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Meeting of the Federal Open Market Committee

December 17-18, 1984

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D. C., on Monday, December 17, 1984, at 3:00 p.m. and continuing on Tuesday, December 18, 1984, at 9:30 a.m.

PRESENT: Mr. Volcker, Chairman
Mr. Solomon, Vice Chairman
Mr. Boehne
Mr. Boykin
Mr. Corrigan
Mr. Gramley
Mrs. Horn
Mr. Martin
Mr. Partee
Mr. Rice
Ms. Seger
Mr. Wallich

Messrs. Balles, Black, Forrestal, and Keehn, Alternate Members of the Federal Open Market Committee

Messrs. Guffey and Morris, Presidents of the Federal Reserve Banks of Kansas City and Boston, respectively

Mr. Axilrod, Staff Director and Secretary
Mr. Bernard, Assistant Secretary
Mrs. Steele, Deputy Assistant Secretary
Mr. Bradfield, General Counsel
Mr. Oltman, Deputy General Counsel
Mr. Kichline, Economist
Mr. Truman, Economist (International)

Messrs. Burns, J. Davis, R. Davis, Kohn, Lang, Lindsey, Prell, Siegman, Stern, and Zeisel, 1/ Associate Economists

Mr. Sternlight, Manager for Domestic Operations, System Open Market Account
Mr. Cross, Manager for Foreign Operations, System Open Market Account

1/ Attended Tuesday session only.

Mr. Coyne, Assistant to the Board of Governors
Mr. Roberts, Assistant to the Chairman, Board of Governors
Mr. Gemmill, Staff Adviser, Division of International
Finance, Board of Governors
Mrs. Low, Open Market Secretariat Assistant,
Board of Governors

Mr. Garbarini, First Vice President, Federal Reserve
Bank of St. Louis

Messrs. Balbach, Bisignano, T. Davis, Ms. Munnell,
Mr. Scheld, and Ms. Tschinkel, Senior Vice Presidents,
Federal Reserve Banks of St. Louis, San Francisco,
Kansas City, Boston, Chicago, and Atlanta, respectively

Mr. Broadus, Vice President, Federal Reserve Bank of
Richmond

Ms. Meulendyke, Manager, Securities Department, Federal
Reserve Bank of New York

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December 17-18, 1984

December 17--Afternoon Session

CHAIRMAN VOLCKER. We need to approve the minutes. No objection. We'll go to Mr. Cross.

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any discussion?

MR. WALLICH. Has anybody on the other side suggested any modification [in our swap line agreements]?

MR. CROSS. Only these two technical modifications have been proposed.

CHAIRMAN VOLCKER. I think it's fair to say the Bundesbank raised the question of whether it was worthwhile having the swap line at all.

MR. CROSS. They asked whether we were interested in continuing it and I told them we were.

VICE CHAIRMAN SOLOMON. That was sheer bluff--a way of getting a message across.

CHAIRMAN VOLCKER. Any other discussion on this? If not, I will entertain a motion, other than Mr. Cross' motion, to renew these swap agreements as amended.

MR. WALLICH. So moved.

MR. MARTIN. Second.

CHAIRMAN VOLCKER. Without objection, they are approved. Mr. Sternlight.

MR. STERNLIGHT. [Statement--see Appendix.]

CHAIRMAN VOLCKER. Any comments?

MR. WALLICH. Peter, you said that non-reduction of the budget deficit was not likely to have a great rate impact unless the economy rises. Does that imply that people believe that, yes, a reduction of the budget deficit would have a substantial rate impact?

MR. STERNLIGHT. I think they believe that a significant reduction would have an impact, yes.

MR. BALLEES. Peter, maybe this is the wrong time to be raising the question, but sometime before we get through here I'd like to have somebody on the staff explain, if they can, what seems to be going on in M1 with this latest big drop of over \$7 billion. Are we looking at seasonal problems, reporting problems, or don't we know?

MR. STERNLIGHT. Well, I would say that there are at least

seasonal problems. But Steve might want to comment.

MR. AXILROD. We'll know better tomorrow when we get some confirmation or not of the data for the last week. At the moment we expect a fairly great rebound, though maybe not an entire rebound. And yet, having looked it over very carefully, I think there was a seasonal problem having to do with days ending with threes compared with four or five and the timing of the Social Security payment, which I'm not sure was properly allowed for. So, I would expect a rebound in the week of the 18th and I'll be surprised if it isn't pretty big.

MR. STERNLIGHT. Based on some of those market surveys taken among the larger banks, people in the market are looking for a sizable rebound from the \$7 billion drop--on the order of \$4 to \$6 billion.

MR. PARTEE. So you want a \$6 billion [leeway], Peter?

MR. STERNLIGHT. I would suggest \$6 billion, yes.

MR. PARTEE. So moved.

MR. RICE. Second.

CHAIRMAN VOLCKER. Approved. We need to ratify the transactions. Without objection, they're approved. Mr. Axilrod, you have presented a little paper on a number of items that don't have to be resolved now but should be resolved by the time we come to 1985.

MR. AXILROD. As I mentioned in the paper, a question that is somewhat but not necessarily related to the Committee's decisions is the importance the Committee may or may not wish to place on M1, which obviously is the aggregate most closely related to reserves. But the first issue is much more an operating issue; the other two are partly operating issues but partly [address] the policy thrust. The operating issue was mentioned by President Morris at the last meeting when he raised the question of the behavior of the funds rate and borrowing when the funds rate got higher [than expected]. The Committee, of course, voted with knowledge that the rate tended to get higher than at the least the staff was projecting at the beginning of each period--except for the last [unintelligible]. Later on there seemed to be some drop in the funds rate as borrowing stayed the same. In trying to explain that [behavior] we raised the possibility that shifts in the demand for borrowing could have occurred in the wake of the Continental problem and the problems with Latin American debt negotiations. I'd like to point out two aspects of this borrowing targeting that do create problems. One occurs when the money supply is weak, not because of these kinds of shifts in the supply function but because of what is going on in economic activity and transactions demands. I do believe that we did get a higher funds rate in the summer for any level of borrowing because banks became more protective of their positions in order to conserve their access to the discount window; they didn't really want to be seen at the window or to have rumors floating around the market that they were in there. In the paper I made an effort to estimate the extent of this effect. We ran through our money market model holding the funds rate at the May level, which was around 10.30 percent, through September. The borrowing level was about \$1 billion. In doing that, we found that we could account for 2 percentage points [less] M1 growth at an annual

rate. We also got 2 percentage points less growth at an annual rate over that period because of the gradual rise in the funds rate from 10.30 to 11.75 percent, given the level of borrowing. I would say that was a supply constraint, given what was going on in the banking system and the way we were targeting but, as I say, a constraint that the Committee accepted. Subsequently, I think another factor was at work. That, of course, was that these higher rates worked through and affected the economy, weakening the transactions demand for money. But it might have been weakening in any event. So, I can't isolate whether it was from that or from other factors that were working--the [unintelligible] working or the inventory cycle, for example. And that also tended to weaken money growth for any given level of borrowing.

Now, the Committee does allow for all this in its operating procedures because as money supply weakens or strengthens there's room for judgmental adjustments in borrowing. But there is not [a provision] for any automatic adjustment in the [current] period. The actual judgmental adjustments in borrowing that have occurred are pretty much on track with what almost 100 percent automaticity would have given in the last month. But they are nowhere near on track with what 100 percent automaticity would have given, for example, prior to the last month. So, if there were any automaticity--as in the period from '79 to '82--borrowing would have been lower well before last month. In light of this, and partly because looking at the data in various ways it seems that M1 is nowhere near as bad a variable as it was in the period from '82 to the first half of '83, I do make a suggestion. It actually is somewhat like the suggestion Mr. Sternlight and I made earlier this year, which was not greeted with open arms by the Committee. That suggestion is to permit a certain degree of automaticity in the level of borrowing, should M1 weaken. The suggestion that I made [in the paper] is really rather moderate--a very small-scale automaticity--because I'm assuming that the Committee would prefer to continue essentially a judgmental approach. But within that general approach, it strikes me as possible to let borrowing fall by a very small amount if M1 is weak. The suggestion there is [to limit an automatic change in borrowing to perhaps] 25 to 50 percent of the deviation in M1 from what is acceptable. That would give you a [typical] deviation, I think, on the order of \$35 to \$70 or \$100 million. Some weeks it would be down; some weeks it would be up. I'm suggesting that we permit that kind of variation and then lever on top of that the judgmental adjustment, should there be a persistent trend weakness in M1 or persistent weakness in the economy or persistent movement of the exchange rate away from what is considered desirable in light of the Committee's overall objectives.

In addition, I think another lesson to be drawn from the experience of the summer and fall is in the area of judgmental adjustments. Traditionally, of course, for judgmental adjustments we look at interest rates, the economy, overall credit conditions, and other similar things. What has happened very recently, of course, is that the dollar has remained high on exchange markets longer than most people expected. With the international sector now becoming such an important element in changes in GNP, it seems to me that under present circumstances among the judgmental factors that might be given a little more weight than perhaps the Committee is used to thinking of would be the value of the dollar. Another I mentioned is, of course, indications of price pressures; one could add almost any indicator to

help in assessing inflationary expectations and the degree of restraint that we might be getting from any given set of credit conditions. Those were comments that had to do mainly with the implementation of operating procedures, Mr. Chairman.

But, of course, the degree to which the Committee either judgmentally, or even to a degree automatically, would want to respond to M1 depends in part on the reliability of M1 as an indicator of the behavior of the future variables about which the Committee is really concerned--which are obviously economic growth and the price level. Dick Porter and others on the staff did some work over the last few weeks in that respect and we're still in the process of evaluating it. But in substance, it seems to indicate that [the reliability of] M1, just looking at its velocity and its predictability to GNP, more or less disappeared over the 1982-1983 period; it was not a variable that one could put any confidence in. Now, when evaluated in relation to other variables such as M2 and M3, it is probably no less reliable in some sort of absolute sense than it was in the period before '82 to '83. From what we can discern statistically, it might be giving roughly the same average amount of information, but the degree of confidence we might want to have in that average amount of information ought to be a little less. That is, the range of variation around what it's conveying is a little wider. And I think that is not an unusual finding, given the kinds of institutional changes that have occurred since we entered this new era of deregulation with different kinds of deposits such as Super NOWs and MMDAs. People are still getting used to them and we're not sure how they're going to behave under various circumstances. So, I would judge from this that if you thought M1 was reliable in the '79-'82 period, with a caveat in a sense that one should be a little more uncertain now, you could think it is fairly reliable now. But I would emphasize that you ought to be more uncertain; that's what the data seem to be suggesting.

Finally, Mr. Chairman, I discussed an issue that has come up in many years--target basing. I focused on the base for M1 because the market and everyone else seems to focus on it as the principal or key variable for the Committee. The question becomes whether to base on where M1 actually ended up the year or whether to base on the midpoint of your target or some such other point of your target. It happens that at the beginning of February at least, the Humphrey-Hawkins Report did suggest that the Committee thought that with velocity behaving somewhat normally M1 might come in around the middle of its target. It was mentioned in the report that if velocity were weak M1 could come in higher; it was silent on the question of velocity being strong. In the event, velocity growth in the year was about 4 percent, which is a shade higher than the average for the second year of expansion in the postwar period--but not enough higher. I suspect, to make a lot of difference in how you look at it analytically. I don't think I need to detail the analysis that is laid out in the paper, Mr. Chairman. I tended to conclude that presentational considerations in some sense argue against rebasing M1. It is a bit difficult to get clear the difference between an actual growth and a hypothetical growth based on your target. But even more importantly, I think it may be difficult to explain, if the Committee wished to rebase this year, why this year and not earlier years. In the past we have often considered a result within a percentage point of the midpoint as success, by which I mean well within the range of variation of ordinary M1 movement. It is probably well within the

range of really unrandom shocks of velocity that probably should be compensated by M1 movements. Further, of course, it has to be noted that the Committee can indicate--and has done so in the past--that it may wish growth to be in the upper, the middle, or the lower portion of the range that it does adopt, depending on what it views as [a desirable] path in coming years. So, that option is open. In essence, this paper tends to be somewhat negative on the question of shifting the base, largely on practical grounds [relating to the difficulty] of explanation. On the economic issue of whether there has in fact been a demand shift that accounts for 1 percentage point lower growth, I tried to remain somewhat agnostic. There is evidence that says there is. You can look at our quarterly model. But I think "within 1 percentage point" doesn't seem like a very good practical argument to be making if growth were 2, 3, or 4 percentage points off. If there are [major] institutional developments we can point to, then I think the argument has practical weight. But I don't think it's a very good practical argument when you're only 1 percentage point off your midpoint. It seems a bit like [unintelligible].

MR. MARTIN. Steve, with regard to the question of rebasing: Are you saying, in the absence of new savings instruments or other institutional changes, that if we were to select the midpoint of the fourth quarter or the midpoint of the year or something of that sort, that based on that rather hypothetical level we would tend to be locked in and have to, in effect, use that procedure in the future?

MR. AXILROD. No, I don't think the Committee is ever locked in, but I think you would have to explain why you rebased this year and not in earlier years when there may have been even bigger misses. And then, of course, you would have to explain why not rebase the next year. I don't think it locks you in to doing that each time at all.

MR. WALLICH. It would seem to me that it locks us in, in the sense that we're accepting the path of the previous year, which may or may not have been right. But if you extrapolate this [procedure] into the distant future, we'll always be on the midpoint of every past cone.

MR. AXILROD. In that sense, yes. I thought Governor Martin was asking the practical question of whether we could be forced in some sense to make the same decision.

MR. MARTIN. Precedent.

MS. HORN. In principle, we [would] never base it on the midpoint unless we were willing to argue that we had reasonable targets, or what we might in retrospect judge to have been reasonable targets, in the previous year.

MR. PARTEE. Well, of course, whatever the money growth was, it was associated with a GNP result. And we would have to be saying also that we found the GNP result to be inadequate, I think, to rebase. The other comment I had is that this is putting a lot of emphasis on the midpoint. My recollection is that we have not emphasized the midpoint of the ranges. We have said that it's a range because we don't know where in the range would be the appropriate number. Of all years, this one we came closer to being within our

ranges for everything than any other year I can recall. So, this burning issue is not really much of an issue this year, is it?

CHAIRMAN VOLCKER. We seem to be talking about this little matter of the base, which I suppose is the simplest to talk about. We don't have to make decisions on any of these issues today. We're just exchanging some preliminary views, so why don't we stay on this particular question for the moment. Frank, were you on this question or something else?

[MR. MORRIS]. I was on the other operating procedure.

CHAIRMAN VOLCKER. Well, let's stay on this one since we started with it.

MR. BOEHNE. I'd like to pursue the operating side too. On the issue of rebasing, it seems to me that's why we have some width in the ranges. I don't recall that we have said that the midpoint was better than the upper or the lower limits. What we generally have said is "Here's the range and there might be certain [circumstances] that would take us to the top end, or maybe even a little over, or to the bottom. So, the idea of making the midpoint sacrosanct in any way is probably too mechanistic--or at least too mechanistic compared to how we've been operating in the past.

MR. RICE. Haven't we said, though, that we expected a particular aggregate to come in at around the midpoint, or above the midpoint, or below the midpoint?

CHAIRMAN VOLCKER. Sometimes we have and sometimes we have not.

MR. RICE. Well, more recently we've stated what we expect.

CHAIRMAN VOLCKER. Not for all aggregates all the time.

MR. AXILROD. In July, Mr. Chairman, the Committee and your report were silent on M1; it was in February when there was a [passing] mention that [growth around] the midpoint [would be appropriate], depending upon velocity.

CHAIRMAN VOLCKER. [We said] in July that we expected M3 and credit to be above [their ranges].

VICE CHAIRMAN SOLOMON. I think there is even less of a case for making a shift in 1985 based on the 1984 results--both for the reasons that Chuck gave and for the embarrassment we would have if we didn't make a downward correction in M3. I just don't see any way we could present anything as drastic as this to the public and to the Congress in a selective way. Down the road we could be facing an accumulation of many misses and it would not be an easy job to stick to this; and, certainly, we can't stick to it selectively. It seems to me that it would be a great mistake to depart from our policy of basing on the actual outcome rather than on the earlier year's targets.

CHAIRMAN VOLCKER. I think we have said from time to time in the past--and I'm not sure whether we said it ex ante or ex post--that

high growth or low growth in the earlier part of the year was fine because it made up for fairly slow or fairly rapid growth in the previous year.

MR. MARTIN. That raises the question of the presentation-- the geometry that is so bedeviling in using that cone. When we start off above or below the line so drawn, if we could express it in terms of some kind of plus or minus a parallel line--.

SPEAKER(?). Yes, I saw them in the Bluebook.

MR. PARTEE. What are those parallel lines? I wasn't clear as to what they were. They're upward sloping.

MR. AXILROD. They're sloped on the midpoint--5-1/2 percent.

MR. PARTEE. Oh, I see. You get the end point and then draw them back.

CHAIRMAN VOLCKER. Congratulations. I thought the staff would never do that. I tried 3 or 4 years ago and could never get the staff to do that.

MR. GRAMLEY. You see they didn't throw the cone out. They just put some parallel lines around it. It makes everybody feel good; you can take your pick that way.

CHAIRMAN VOLCKER. I think once before we drew M1 that way. Does anybody else want to comment on this rebasing question? I have not detected a lot of sympathy for it.

MR. MARTIN. I would agree with Tony that it looks as though it's a major move. It's hard to explain. I don't think it is a very good idea.

MR. BLACK. It's hard to explain that you're aiming at a rate of growth from someplace you aren't.

MR. RICE. The presentational problems are insurmountable.

CHAIRMAN VOLCKER. If we continue to get \$7 billion declines in M1 for the next few weeks--

MR. PARTEE. Yes, you might have to do--

CHAIRMAN VOLCKER. [Unintelligible] something even less than that. Nobody else has comments on this question? We had a couple of people who wanted to talk about the operating procedure. Mr. Morris and Mr. Boehne.

MR. MORRIS. Mr. Chairman, I appreciate the memorandum that Steve wrote. I'm not very enchanted with the idea of solving this problem through automaticity. It seems to me that that would be a step backwards toward the kind of interest rate volatility we think we have gotten away from. But I do think that in a situation where the Manager finds that he cannot attain his total reserve path and at the same time produce the assumed level of borrowings--which is the case we had this summer--there is an incompatibility in the instructions to

the Manager and it ought to be resolved not in some automatic way but by having a conference call to the Committee. I suspect we may well have the opposite case in '85 at some point, with total reserves growing faster than the original projection because the Manager is just pushing in nonborrowed reserves at an increased rate in order to meet the borrowing projection. I would have the Committee decide--on the basis of what is happening to interest rates, the economy, the money supply, the exchange rate, and everything else--how we should deal with this incompatibility in the instructions.

CHAIRMAN VOLCKER. I'm not quite sure what you're getting at. There is no instruction on total reserves, the way we have it now. Maybe there should be.

MR. MORRIS. The total reserve path comes from the Committee's objective with respect to the aggregates. [Required reserves are] plotted out first and then the Manager puts in the [excess reserve allowance] and then the assumed borrowing level is subtracted to form a nonborrowed reserve path. So, although we've [not] talked about a total reserves path, that's implicit in the whole operation. The problem this summer was that the Desk couldn't hit the total reserve path because it was following a nonborrowed path that was related to a level of borrowing that the market was not doing.

VICE CHAIRMAN SOLOMON. Wasn't the more meaningful incompatibility this summer the fact that we weren't getting the fed funds rate that one normally would associate with the nonborrowed reserve path? And that was because of the changes--

MR. MORRIS. That was a product of the banks' aversion to using the discount window, which was reflected in a lower-than-expected level of borrowing relative to the interest rate.

VICE CHAIRMAN SOLOMON. Well, what would you do about that?

MR. MORRIS. My thought is that we'd have a conference call and the Manager would say that we have a situation in which the banks appear to be averse to borrowing from the window and as a consequence they're [bidding] up the funds rate and we're not getting the level of borrowing that we expected to get. The question to the Committee then would be: Do we want to reduce the borrowing level or not?

CHAIRMAN VOLCKER. We don't have to have a conference call; we have a meeting.

MR. PARTEE. Yes, we discussed that at a meeting and decided to let it roll.

MR. MORRIS. I'm talking about in between meetings, if we have an incompatibility in the instructions by this definition.

MR. MARTIN. But if the FOMC had chosen some percentage [of automaticity], say, 25 or 50, the Committee would know a priori what form the implementation would take.

MR. MORRIS. Yes, but there may be times when we might want to adjust the procedure and times when we might not, depending upon the circumstances. I'm rather disenchanted with automatic adjustments

after our experience of recent years. I'd be more comfortable with a judgmental assessment as to what we ought to do to reach our objectives.

CHAIRMAN VOLCKER. I'm not sure I fully understand. You had the chance during the summer in a meeting, whether or not we had a conference call. You had repeated chances in September, October--. How many times did we meet this fall? Nobody wanted to do anything about it.

MR. AXILROD. The relevant meetings were July and August.

MR. MORRIS. I forget which meeting it was, but we had an unexpected rise in the funds rate. To my knowledge and my recollection, nobody on this Committee contemplated the funds rate going above 11-1/2 percent even though we had a 12 percent [upper limit on the] range. That was not the expectation given in the Bluebook as to what the course of action chosen by the Committee would produce in the way of the funds rate. The funds rate rose from 10-1/2 to 11-1/2 percent, not because of any overt decisions on the part of the Committee but because of the change in attitude on the part of the banks to borrowing. Now, the question was: Should we have responded to that by lowering the borrowing? That's my question.

CHAIRMAN VOLCKER. I understand that question. But I say that at least once the Committee had a meeting and--for a while, anyway--said no. And the opposite happened this fall.

MR. MORRIS. I think it's quite clear with hindsight that we should have said yes. But that is clearly hindsight. However, I would much prefer that sort of procedure to an automatic response on the part of the Manager in putting in a certain amount of reserves.

VICE CHAIRMAN SOLOMON. I would agree with you on the automaticity. I think there are problems with that. But, let's face it: In practice there is a modest range of flexibility based on consultations of the Manager and Steve Axilrod and the Chairman. We have recognized that, I think, by talking about some flexibility. In particular, at the last meeting we delegated some flexibility around a modest range. Basically, there are three people who make those decisions. I think it would be very awkward and difficult to have a consultation every time. What we are seeing now, and I think it's working fairly well, is that when there is a need to make a larger change in the borrowing, then the Chairman has a consultation. I don't really see that there should be changes in practices for times that might require some more immediate, flexible, and minor adjustment. Those adjustments are done now basically. Sometimes the Desk waits a day or two before draining or adding reserves. There is some flexibility now based on the tripartite approach we're following, keeping an eye on interest rates as well as on hitting the reserve path. I'd agree with you: I don't particularly like the idea of even a partially automatic adjustment; it just seems to me that what we're doing now makes a good deal of sense. I really do feel that we had the opportunity to take whatever action--a change in the borrowing--was necessary to get the funds rate that we were all thinking of. In that sense I agree with the Chairman; I think we had the opportunity. But the economic events were changing at the time--the economy seemed to be overheating and, therefore, we really didn't object to the fact

that we were getting a higher fed funds rate. The majority of the Committee was comfortable enough with the situation.

MR. MORRIS. Well, maybe I'm proposing something we're already following. On the other hand, I think there is some merit in thinking of it in terms of a total reserves objective.

CHAIRMAN VOLCKER. We've not focused on that aspect of it because reserves have been falling short for some time. They are well below the mark. Mr. Boehne, I think, expressed a desire to talk earlier. I have a note here that Manufacturer's Hanover has cut its prime rate to 10-3/4 percent.

MR. BOEHNE. On this judgment versus rules debate, there are different kinds of views as to how you can apply judgment. You can have a judgmental approach which says that when things don't go according to plan you look at the money supply and reserves and foreign exchange and so on and then make a judgmental response to whatever the deviation is. In that kind of approach, in effect, it takes positive evidence to make a change. Or you can have a judgmental approach which says that if we were on an automatic response of some kind, this is the way we would go; now, are there any good reasons why we might not want to go in that direction? So, in that sense, you need negative information. In the way this is carried out, is it more the first kind or the second kind or is it somewhere in between? I'm not sure.

MR. AXILROD. The degree of automaticity we're suggesting is so minimal that I suspect it would hardly be seen in the market at all except that to a minor degree it might temper the timing, at the margin, of Mr. Sternlight's operations. Therefore, it is really more of the second kind of indicator--that your judgment ought to be in this direction and here's a small step in a way that might even be reversed in the next two weeks if the aggregates pop back up. At least I have in mind more of the second kind of approach, in spirit. It wasn't that you would stop it, but it's so small that it isn't going to have any very significant effect until it really accumulates substantially.

MR. BOEHNE. So it's not really automaticity in the pure sense. It's a direction in which your judgment ought to be leaning and which you ought to follow unless there's a--

MR. AXILROD. There's a small step in that direction but one that I do not think will be noticeable in the market, given the variations we've had in the borrowing/funds rate relationship.

MR. BOEHNE. But in reality how does that differ from what happens now?

MR. AXILROD. Well, it gets you started and it tones up your thinking, I think. The word that comes to mind is "excuse," but I don't mean it in a bad sense. It gives you a reason to be thinking in that direction--to start something so that you don't say it's just a feeling in my gut that's moving me. It's a reason, in some sense.

MR. BOEHNE. So, it's really a fairly subtle shift from what happens now?

MR. AXILROD. That's all I had in mind.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLES. I would like to speak up in favor of some degree of automatic response, as Steve set forth a good case for it in his paper. In fact, the whole paper was a badly needed new look at our operating procedures in the sense of some general dissatisfaction by many of us--with the benefit of hindsight now--with how the second half turned out in terms of our money targets and interest rate levels and similar matters. I would have to say, though, with respect to our current operating procedure or even the amendment to it that you are proposing, Steve, that I think we're still going to be subject to all the weaknesses that we found way back in the 1960s with respect to free reserves. Any given level of borrowing or any given level of free reserves is compatible with a wide range of interest rates, a wide range of different economic outcomes, and a wide range of possible growth in the monetary aggregates. That's what we experienced so many years ago. I'm afraid we're still working with a tool that has those built-in disadvantages. So, while I personally would be in favor of going along some sort of semi-automatic route of the type Steve described, I think we also ought to consider, as an alternative to that, some semi-automatic targeting of nonborrowed reserves, which is after all closer to what we're really trying to control--the monetary aggregates as our intermediate targets. We don't need to get back to a full automatic pilot. Even if we were to go back to nonborrowed reserves targeting, we could also introduce some semi-automaticity simply by making judgments as to the degree to which the nonborrowed reserve path would be varied in response to a deviation of money from path. I'm pretty much convinced at this point that that kind of approach would be superior over the longer run than something hooked on the borrowing target. [The latter approach] most recently, as well as many years ago, has demonstrated the kinds of weaknesses that concern many of us.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I end up very close to John Balles on this. I'd like to say first of all that I agree that Steve has done a very fine job on this memo and, as some of you might suspect, I think he is right in saying that M1, despite all its imperfections, is probably still the best target. So, I would favor tightening up the targeting procedures on that so that we could more nearly hit our targets, which leads me to favor, as he does, some degree of automaticity. I think Steve's suggestion of about 50 percent of any deviation of required reserves from path would be a pretty good place to start. But I still entertain hopes that someday we're going to get to a total reserve target and a penalty discount rate, because I believe ultimately that that's the best hope we have for really getting to the point we want to go. I'd also like to mention the point that Steve made about the difference between a net borrowed reserve target and a fed funds target. I think that's a point that has escaped many of us. There are some differences there; maybe they are differences of degree. But if in fact there is a greater degree of fluctuation in the federal funds rate under the borrowed reserve targeting, I think that can give us good information, as Steve suggests, unless of course the change in the federal funds rate comes because of a shift in the borrowing function or something of that

sort. To me the main point that really comes out of this paper is that it generally underscores the need for not less fluctuation in the federal funds rate but more fluctuation in order to achieve our targets. And that in turn calls for more frequent and maybe larger adjustments in the borrowing target to reinforce these desirable movements in the federal funds target. In short, I think that the present procedure, when we restrict the limit on fluctuations in the federal funds rate, is not that much different from targeting the federal funds rate. I would like to strengthen it so that we really do take more advantage of the differences that exist between those two basic procedures.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Well, I don't think I really want to change anything, and I guess I have a couple of reasons. First of all, I think that this whole debate about automaticity and targeting procedures and everything else is very germane as is this reliability question that Steve talks about in his memorandum. And on the reliability of M1, I must confess that I'm more skeptical, not less. In my judgment, these various equations under the best of conditions don't leave one very comfortable; and I would emphasize that those equations by definition are the best of conditions because among other things they incorporate all the historical data revisions. Apropos of that, even as we sit here today questioning what happened in the first half and the second half of this year, I think there's at least a 50-50 chance that by the time the jury is in and all the revisions are made M1 is going to look a lot different for the year 1984 than it looks right now.

MR. PARTEE. The pattern within the year?

MR. CORRIGAN. Yes, the pattern within the year. In other words, the second half will be a good deal stronger and the first half will be a good deal weaker. I don't know that for certain but, as I say, there is at least a 50-50 chance of that and that's just the first revision. There will be several others down the road. So, I think the question of the reliability of M1 just in the narrow and empirical sense of the numbers themselves is a very, very important aspect of this question of automaticity. Partly for that reason but for many others, as Tony and others have touched on, I think it would be a mistake to make any move in the direction of a more automatic response no matter how marginal it may seem. Having said that, I too have my frustrations--not so much with the apparatus, but in some very real ways with the environment within which it works. Clearly, at least in my judgment, during this year and last year the Committee has moved in the direction of looking through reserves, M1, and all the Ms and looking more--perhaps not in a systematic way but in a fairly deliberate way--at the economy, exchange rates, prices, industrial production, and all the rest of it. And part of what we're seeing, in my judgment, is nothing more than the fact that the economy on both sides has surprised us in a significant way throughout this period. And because the economy has surprised us, we have found ourselves in the position where the need to make these flexible adjustments has seemed to the Committee as a whole to be a pressing need. I think the fact that those adjustments were made and the way that they were made over the period as a whole basically constituted a pretty solid approach to policy, recognizing that we're never going to be able to

fine-tune this; that's just not in the cards. Some of the frustration that we all feel at times I think has to do with the fact that these adjustments are made in intermeeting periods and we all have our personal subjective biases as to which are most important and which are least important in the laundry list of things that we put into the directive--whether it's the exchange rate, or M2, or M22, or the GNP, or whatever. And because our personal biases may differ a little in terms of where the priorities lie, there may be differing degrees of frustration in terms of whether and how much of an adjustment is made in the borrowings target, particularly against the background of the appropriate inhibition against treating any of those intermeeting consultations as a meeting [requiring] a vote on all the rest of the apparatus that could go with it. My bottom line, Mr. Chairman, is that I think the apparatus works pretty well, particularly against the background of my personal skepticism about M1, and I think the frustrations that we all feel at times are almost inevitable. But compared to the alternative, I think those frustrations are quite manageable.

CHAIRMAN VOLCKER. Mr. Forrestal.

MR. FORRESTAL. Well, Mr. Chairman, I have a good deal of sympathy for what Jerry has just said. On the other hand, it does seem to me that Steve's paper made a pretty compelling case for some degree of automatic response. I think that's particularly true when the demand for money is stable and we're not getting noise from other factors. I would really hate to see us get into a position of having conference calls of the Committee to deal with very minor issues that come along from time to time. But having said that, I too have a little hesitancy about the reliability of M1. Certainly, it's a better aggregate than the others we've been dealing with, but we've had some variations in M1 recently--and over the past year in fact. Because of that, I would like to keep any degree of automaticity to a minimum. But the scenario in the regime that Steve has outlined in this paper seems to be somewhat of a compromise between those who would move to a fully automatic response and those who wouldn't change it at all. I guess I would feel more comfortable if we had some degree of automatic response, but I would have to admit that as I look back over the past year I don't think policy would have been changed very much at all if we had had this kind of automatic response. But, I think to fine-tune it a little would be in order.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. Let me make a clarifying point first, and that is that there are at least two operating issues that we started talking about and they don't have anything to do with one another necessarily. One is the level of borrowing and whether or not the federal funds rate in relation to the level of borrowing is where we thought it was going to be. And the other is how we respond to unexpected deviations of growth in M1 from the path laid out ahead of time. Now these two happened to be closely related this summer, but that was an accident. One has to deal with those two problems quite separately. I can easily think of an example in which the opposite sort of relationship began to develop between borrowing and the federal funds rate and the kind of automaticity we're talking about would have made things go in the wrong direction. The automaticity issue relates strictly to whether or not we respond more quickly and

more sensitively to changes in growth of M1 relative to path than we have in the past. I'm very much with Jerry on that and I would put it this way: that we haven't been frozen in stone between FOMC meetings. We've evolved a procedure over the course of the past couple of years in which we instruct the Manager on what he's supposed to do when these deviations occur, and why, taking into account a whole lot of things. And in a world in which if money demand is stable from one quarter to the next it isn't necessarily stable from one month to the next, I think that is a lot more sensible response to deviations of money growth from the path than an automatic response.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, I think the word "automatic" ought to be banned from this discussion because I don't think there's anything automatic really being proposed. What we're talking about is some procedural rules that would be followed unless there is some reason for not following them, as is always the case with the Federal Open Market Committee. Before, we had a rule that we would provide the nonborrowed reserves consistent with the money growth we wanted to get and then borrowings automatically fell out. Now we set the level of borrowing and the reserves automatically fall out--the reserves associated with whatever the demand for money does and what occurs. What Steve is proposing is simply that one other way of dealing with this as a rule for operating procedure would be to go between these two extremes and split the difference. I think that makes a lot of sense. And the reason that I think it makes a lot of sense is that I've never known the time when in the first instance anyone could be certain enough that they ought to do something and, in fact, did it. We always have an ambiguous situation. It's always ambiguous. You could say in looking back as well as forward that maybe we ought to let M1 growth fall off [its path] because, after all, the economy has been strong and there are a lot of inflationary expectations out there. And it could turn out to be wrong: The economy isn't strong and there isn't the inflation expectation. But by the time you've learned that, a couple of months have gone by. It seems to me that some adjustment in the borrowing level to take account of the fact that M1 is falling off path is a reasonable thing to do. Now, as you all know, I've practically given up on having any view that anyone can look forward with a degree of certainty and, therefore, I'm always looking for the safer course. It would have been safer this summer, certainly, had we done it that way--and it might well be safer in the other direction looking forward in the next year--because we would have had quicker adjustments. The funds rate would have dropped faster had we followed the rule and it may go up faster if we follow the different procedural rule in the year ahead. And I think it's a better way to go. But, again, it's nothing but a procedure. And if the Chairman or Steve or Peter or anybody else feels that there is something odd that has accounted for this, there is no reason we can't get together and say "Well, there's an oddity here; I think we ought not follow this rule."

CHAIRMAN VOLCKER. Just in the interest of accuracy, let me redescribe what I think our techniques have been during this period. You said the contrast was between (1) setting a nonborrowed reserve path, keeping it, and the borrowings would fall out and (2) setting the borrowing and the nonborrowed reserves would fall out.

MR. PARTEE. In the first instance.

CHAIRMAN VOLCKER. The correction I wanted to make was this: That may be true in the first instance, but we have always made adjustments either to the nonborrowed reserve path or now, conversely, to the borrowing, depending upon what the other was doing. You're talking about some bias when you're talking about this technique. But these things that Steve is talking about are so small that they're way within the discretionary adjustments we were making anyway with either technique. We make discretionary adjustments when the Committee permits it.

MR. PARTEE. I do think that one's attitude toward this is strongly shaped by how much one believes in M1. In fact, I've kept a tally so far and that exactly identifies the positions.

CHAIRMAN VOLCKER. Well, we have to get back to that subject, too. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I would start out with the premise that maintaining as much flexibility as possible is the most desirable course for the Committee. It does, however, turn [out that] the Chairman and the staff who work with this on a daily basis have a great deal of discretion, I think, within the very broad directive that the Committee adopts for the intermeeting period. Having said that, however, I am attracted somewhat to Steve's proposal because of its directional content if you will. It seems to me it is so small that it will not alter policy, particularly in the public's view or the market's view, but it will give the Committee some indication as to what the Desk is doing or what it's thinking about on a day-to-day or week-to-week basis. If the borrowing level were adjusted by as much as \$20 million or \$50 million at a particular time, then it's a clear indication that the people who are looking at it and making those judgments are indicating that money growth is deviating from what they believe the Committee directed at its past meeting. And in that sense, it seems to me it would be very helpful to me as a participant in this organization and would not do great damage in the sense of disrupting the markets or [producing] wide swings in the interest rates. As a result, I would be in favor of moving in this direction in the very modest way that Steve has proposed.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, we seem to be having a low key version of the discussion of rules versus discretion. To me good discretion or good judgment is always bound to be better than a mechanical rule. The question is whether good judgment is more likely than not. We went to automaticity in 1979 because we felt that in the past discretion or judgment had caused us to move too little and too late so, in effect, we forced our hand by automaticity. That, it seems to me, has not been our problem recently. We've had a great deal of discretion and the discretion I think has been sound. So in terms of recent results, there isn't a great deal to be said for going back to rules or automaticity. I do have a sense that this need not always be the case. Sometimes judgment can be right; it can be wrong. Maybe there is always a danger in this Committee, as in others, of doing unpleasant things too late and too little. Against that I think one

can guard by having a small injection of automaticity. The upshot of my points is that we have fewer meetings a year than we used to have and we don't particularly want to have conference calls, but I certainly wouldn't want to go back to where our hands were tied excessively and where the automaticity of the rule got the better of our judgment.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. I'm sorry, Mr. Chairman, but I was so busy a while ago making a case for automaticity that I neglected to say that I did not mean to rule out discretionary adjustments in the borrowing targets. I think those we've made recently have been very appropriate. I would want to augment the automatic part of it, if we vote for that, with discretionary movements such as we've had, if it appears those are desirable.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Mr. Chairman, unless I'm missing something, it seems to me the issue is not rules versus discretion but rather rules for exercising discretion. I think the discretionary aspect is certainly there--at least that's what I'm interpreting Steve to be saying. It's pretty much a confirmation of what has been going on but with just a small amount of added comfort level to the staff in terms of doing what they have had to do. It seems to me that giving staff just the slight amount of latitude that Steve's talking about makes sense. I think anything excessive or any apparent trends or anything unusual would certainly come to the Committee and would come very quickly. I just think there's a certain degree of comfort level here that would be helpful to the staff, but I don't think it would be giving anything away from the standpoint of what the Committee is trying to accomplish. My bottom line is that I don't have any real problem with this.

CHAIRMAN VOLCKER. Miss Seger.

MS. SEGER. I admit to being confused--to make a general statement. The second thing that strikes me is that whether or not I think M1 is important, there are a lot of Fed watchers who do. So, maybe it's like gold: It isn't the theoretical matter but whether a lot of people assume it's important that makes it important. It's hard for me to divorce the slowdown in M1 growth from the very dramatic drop in total reserves. And just hearing Jerry Corrigan's remarks about the slowdown in the economy--that this is what produced the M1 slowdown--it is as if the Fed had nothing to do with the slowdown. I think it is pretty hard to argue that either we had nothing to do with the slowdown in the economy or the slowdown in M1. Also, I heard in the past couple of meetings concern about allowing the fed funds rate to drop much because then we might have to retrace the steps and jerk the economy around and or jerk the markets around; yet when the funds rate shot up from 10-1/2 percent or so to 11-3/4 percent, which did jerk the markets tremendously, I didn't hear the same kind of concern. So, again, I don't know the answer to this, but somewhere along the line I think we've got to make some changes.

MR. CORRIGAN. Let me just clarify [my comment]. I think you misunderstood me. What I was saying was that when all is said and

done the slowdown in M1 that everybody is so concerned about right now might not even be there in the final figures.

MS. SEGER. Yes, but I think the slowdown in the economy is real. That's all I'm saying. And I think there is some association between that and what happened to monetary policy, particularly if you want to look at total reserve creation since late spring.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. It seems to me that for many of the reasons that have been stated these are the kinds of decisions that lend themselves to judgment based on a variety of circumstances that can change very significantly from time to time and it's very hard to prejudge them. The only other thing I might add is that moving to some kind of mechanical procedure, which I think is what this suggests, is a bit of a slippery slope. If we begin to move in this direction and become very mechanical, it opens up the possibility that our critics would suggest that the whole procedure runs itself from a higher level of mechanical procedure than we're using. So, I would be very much in favor of staying with the procedures we're presently using.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Mr. Chairman, on this issue I would line up with Governor Wallich, Governor Partee, and Bob Boykin. I think that Steve's proposal is very little different from what we're doing now. I don't see the lines closely drawn between judgment and automaticity. It seems to me that as long as we limit the automatic changes--especially on the low end--to 25 percent rather than 50 percent, the result would be little different from the procedures that we're following. That is especially true if you keep in mind how flexible this Committee has been all along. In my experience since I've been on this Committee, there has been no reluctance to superimpose judgment on any kind of arrangement that we had agreed to earlier. So, I'm confident that judgment, and hopefully good judgment, will always be there superimposed upon any slight automaticity that we agree to go with. And I think the advantage of 25 percent automatic changes is that it keeps us going in the right direction without over-committing us.

CHAIRMAN VOLCKER. Everybody is willing to impose judgment, so long as it's their judgment!

MR. MARTIN. Well, it seems to me that Steve's paper indicates that the reason for this proposal--other than the fact that proposals in Washington never die, they just come back around after a while--is that he detects a tendency to accommodate in part undesired swings in money demand. I suppose that is a more eloquent way of saying that we tend to be a little too late in our movements, depending in part on the direction of the so-called undesired swings. If that's true, then it seems to me that there is merit in this proposal in terms of "expectability." One would know as a member of this Committee, within these very small gradations, the move that would take place. I have confidence in not only my own judgment but in that of the Chairman, vis-a-vis his immediate comment here. And I'm sure he would in appropriate circumstances overrule the rule. What we're talking about are small gradations. In the example given,

if you start at \$650 million of borrowing, the \$70 million [change] for the \$2 billion deviation from what I take is a quarterly path, gets us what--25 or 30 basis points change in the fed funds rate, or something of that sort and a 25 basis points change in M1 [growth] or 50 basis points or something like that? We're talking about finite gradations of change, whatever the numbers are.

CHAIRMAN VOLCKER. But you think they're that much?

MR. PARTEE. No, I don't think it's that much.

MR. MARTIN. It wouldn't get you that much?

VICE CHAIRMAN SOLOMON. The rule of thumb is a \$100 million borrowing level change gives you 1/4 point [on the funds rate].

MR. MARTIN. Well, these are small gradations. And it seems to me that that argues for building in some technique useful in [making] the judgment. If we adopt this, I think this Committee should from time-to-time set that percentage [rather than] simply accept 50 or 25 percent, because isn't it true that the impact would vary depending on the level at which borrowing started? So, I would say this is a good idea, but let's have some setting of the percentage.

CHAIRMAN VOLCKER. Just for my own edification: When you say the result is \$25 million, what are you assuming that's related to--a \$1 billion change in M1 or something?

MR. AXILROD. Well, I was assuming a 7 percent reserve requirement on transactions accounts.

CHAIRMAN VOLCKER. Yes, and how big a change in M1?

MR. AXILROD. I used as an example that a \$2 billion change in M1 produces--

MR. PARTEE. \$35 million.

MR. AXILROD. --\$140 million on required reserves. Half of that is \$70 million and 25 percent of it is \$35 million.

VICE CHAIRMAN SOLOMON. And you would react every two weeks.

MR. AXILROD. What I had in mind was: [Suppose] you had a nonborrowed path based on \$1 billion [of borrowings] and in this two-week period it began to appear that M1 was running \$2 billion below [path]; M2 and M3 were not behaving so differently to override it--that, of course, would be in there. And the Manager wouldn't reduce nonborrowed by the full amount [implied by] the shortfall in M1.

CHAIRMAN VOLCKER. A few people commented, favorably or unfavorably, on what they thought of M1. Does anyone else wish to make comments on what they think of M1? Unless you have changed your mind, you don't need to raise your hand.

MR. MORRIS. Mr. Chairman, I don't want to miss this opportunity. I would simply say that several times around this table

in the past few years I've heard the statement that now M1 has restored its normal velocity relationship. And I've always noted that this turned out to be a very temporary phenomenon.

VICE CHAIRMAN SOLOMON. What about credit velocity, Frank?

MR. MORRIS. I also note that, beginning next year, the minimum deposit on Super NOW accounts drops down to \$1,000. I don't know what impact that is going to have. I don't see much of a marketing effort around New England to do this, although there's a lot of activity in the money market deposit accounts. A lot of the banks have already announced that they're going down to a \$1,000 [minimum] on money market deposit accounts. But I think M2 could be impacted. [Unintelligible] after a few months in which the gap between what we would have expected M1 velocity should be and the actual drops down to close to the normal range. I think we ought to consider this, until we have a lot more evidence, as sort of a random distribution of velocity for M1.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. I'd just like to remind us that we're going through a period now in which the money numbers have been weak and the economy is weak. So we say to ourselves "Oh, I wish we hadn't let that happen." But the safer course is not always the one of either slowing down money growth at this point too fast, or speeding it up at this point too slowly. I want to take you back to that period from October of 1981 until April of 1982 in which we had a growth rate of M1 in the range of 9 to 10 percent. Had we permitted the kind of growth that the economy needed to turn around, it would have been 15 percent. The safer course in that case was not to resist the growth of M1 but to let it happen. Now, that was a case in point in which the money demand function that we were using was just miles off track. And I don't think we should decide that just because M1 has been behaving reasonably well roughly since the middle of 1983--we have a little less than 18 months' experience--that this number is now going to be a safe guide for the future. I don't think it will be. I agree with Frank entirely.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. I didn't comment on M1. I would not be prepared to restore it to its original grandeur. On the other hand, Lyle, I think more of it than I have in recent times. I feel it's probably as good an indicator as we have now. So, I would put a little more emphasis on M1 now.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. Well, I'd like to concur with Steve's assessment of what has been happening to M1 recently. There is never any indicator that's going to be perfect. I think M1 has exhibited some stability recently, more than it did in the earlier period. But whenever I hear this criticism of M1, I have to ask: What are the alternatives? And the alternatives--such as M2 or M3--are even worse as far as I can tell. And the worst one of all in my personal opinion is the "look at everything" approach, which generally leads to confusion and indecision and action that is taken much too late.

There's a tendency when one looks at everything to fail to distinguish between the leading indicators and the current indicators and end up not doing anything right. So, given the alternatives, I would still come out for putting more emphasis on M1 than many of you. I think that will guide us better than these others.

CHAIRMAN VOLCKER. How many people would like to put primary emphasis on M1?

MR. PARTEE. Of the aggregates?

CHAIRMAN VOLCKER. No, of everything. We're not deciding anything today. Who would put primary emphasis on M1 in the conduct of open market operations?

MR. GRAMLEY. Well, isn't that what we're doing now?

MR. RICE. No, I don't think so.

MR. PARTEE. No, no. [Unintelligible] among the aggregates.

CHAIRMAN VOLCKER. I see a few hands go up weakly and then they go down again.

VICE CHAIRMAN SOLOMON. But what you're really saying is a policy with the emphasis on M1 and the mechanical feedback--the same as from October '79 to the end of '82.

CHAIRMAN VOLCKER. [It would] certainly go in that direction, but whether or not it's mechanical--. Who would put primary emphasis on M1?

MS. SEGER. Versus the Ms or including total reserves?

CHAIRMAN VOLCKER. Everything. Primary emphasis.

MR. PARTEE. The economy, inflation--?

MR. BOYKIN. It would be awfully important, but I would still want to keep my eyes open to--

CHAIRMAN VOLCKER. I said primary; I didn't say exclusive.

MR. BOYKIN. Okay.

MR. KEEHN. It has a role involving something from which we make a judgment?

CHAIRMAN VOLCKER. Primary relative to anything else.

MS. SEGER. Okay.

MR. WALLICH. It's a matter of the magnitudes of everything else. If the economy collapses, I would not go with M1.

CHAIRMAN VOLCKER. Well, fortunately, we don't have to do anything about this today.

MR. GRAMLEY. Merry Christmas.

CHAIRMAN VOLCKER. I'm not very happy with this proposal of Mr. Axilrod's. I'll tell you this: It's Mickey Mouse in my opinion. I don't see anything the matter with it, but it's trivial in a way. Let me give you two reasons why. I would point out that the money supply has been steadier when we depressed its importance and the automatic responses we have given to [the aggregates]. Not so many months ago we were being praised by the monetarists for this new way we had found to keep the money supply steady. I at least am suspicious that it's not entirely accidental--that any reaction we make to it of a sharp kind is after the fact and affects things with a lag. And it may send things off in another direction. So you get sine curves instead of stability. Nobody has talked much about the fact that we are working with economic projections and I find, just as a pragmatic judgment, that the Committee puts tremendous weight on them. The economic projections are consistently unreliable in terms of the ex post judgment that's made about what the satisfactory quarter-to-quarter movement is in the economy. And I think that's just a fact of life; it's not that the projections are any worse than anybody else's. You can't project the economy quarter-to-quarter or half year-to-half year with a degree of sensitivity that is required ex post to make everybody happy. That's another way of saying you can't fine-tune on the basis of economic projections.

I find the Axilrod approach--I call it the Axilrod approach though he was responding to a request--a little narrow because it's focusing on whatever M, M1 presumably. Maybe the more relevant question, or at least as relevant a question, is whether we shouldn't be putting more weight on other indicators of what is happening. We have an exchange rate that in my judgment is wildly out of line with the needs of this economy over a period of time. And it should have been telling us something for a long period. We've had commodity prices falling rather sharply for six months now, I guess, during a period when economic projections were pointing in quite a different direction. Commodity pricing didn't prove to be the worst economic indicator in the world. And it tells you something in that it makes a policy difference as well. How well you do it in the first [unintelligible]. The only reason I would worry about the Axilrod proposal is that I wonder whether we'd be kidding ourselves by making this little automatic rule, if I may call it that, [and if] that would inhibit making discretionary changes. It is so minor in and of itself that it doesn't do much. And if the Committee sits around and says "We have this automatic response mechanism so that's all we're going to do"--if that's the psychology of it--we may not be responding often or fast enough. I don't know whether it would work out that way, but I'd be a little suspicious.

MR. BLACK. Mr. Chairman, when we made a 100 percent adjustment we did have these ad hoc adjustments made and I think we should continue those. And if this is Mickey Mouse then I'd like to kick it up to 100 percent and then--

CHAIRMAN VOLCKER. I agree. You can argue the opposite. We used to do it 100 percent.

SPEAKER(?). We'll have to go for Pluto!

CHAIRMAN VOLCKER. Well, this [unintelligible]. But there must be something drastic about doing more than that.

MR. PARTEE. Certainly in the past we've found that we had to adjust by more than the change in required reserves in order to get the desired change in the aggregates.

MR. RICE. No, that's--

CHAIRMAN VOLCKER. Oh no, we are--

MR. PARTEE. This is just a portion of the change in required reserves.

CHAIRMAN VOLCKER. [Unintelligible] you're getting a wiggle in M1, too.

MR. AXILROD. I don't know if it's of interest, Mr. Chairman, but I did work out--I couldn't do it dynamically--what the hypothetical borrowing at 100 percent in "automatic" adjustment would have been between Committee meetings starting over each Committee meeting and not assuming any adjustment in the figure. And what this shows is that in June and the first half of July this hypothetical level of borrowing would have been about \$100 and some odd million above the \$1 billion that was used consistently in that period for the path. The actual turned out to be a shade under \$1 billion. But in the last half of July and the first half of August, with a 100 percent adjustment the hypothetical level of borrowing would have been on average \$350 million less.

CHAIRMAN VOLCKER. \$350 million less than the \$1.1 billion that we didn't make the previous time or than the \$1 billion?

MR. AXILROD. No, the billion--always carrying it at the billion. I didn't know how to assume what was going on. And then in [the second half of] August and September we began lowering the level of borrowing judgmentally, so the last half of August was \$1 billion and then September 12th it was \$900 million and September 26th, \$850 million. The [respective] hypothetical levels would have been \$870, \$680, and \$760 million--so, running a little lower still. And then in October when we had been running with \$750 or \$700 million, the hypothetical would have varied between \$65 and \$505 million. And then in November--

CHAIRMAN VOLCKER. Only \$65 million--practically no borrowing?

MR. AXILROD. Practically no borrowing, yes. And then in November, they're very close.

CHAIRMAN VOLCKER. That's with 100 percent?

MR. AXILROD. That's with 100 percent. That's just the whole drop in required reserves against M1.

MR. PARTEE. Because September was the way it was?

MR. AXILROD. Yes.

MR. CORRIGAN. What would have happened if the federal funds rate went all over the place? Then the money supply would have been all over the place too.

MR. AXILROD. Well, I guess what would have happened is that the funds rate, instead of rising in the course of July and August, would have been back down closer to the 10, 10-1/2 percent area, but that's--

VICE CHAIRMAN SOLOMON. We wouldn't let it go down to \$65 million, I presume. We would cut the discount rate.

MR. AXILROD. I assume the judgment would override.

MR. BLACK. Jerry, I think that's an empirical issue. There is reason to suppose that but, if the market saw us hitting what they thought we ought to hit a little more regularly, I'm not sure that we'd have that wild a gyration. We might. But I don't think it would hurt a lot if we did have it in the federal funds rate--

MR. CORRIGAN. Well, in the abstract that might be right. But on the basis of experience I see nothing that suggests that one can disentangle the behavior of the federal funds rate from these other short- and long-term rates. Now, in theory, they should be able to be disentangled.

MR. GRAMLEY. That was the theory proposed in October of 1979; it just didn't work.

MR. CORRIGAN. That's what we tried. And look at the behavior of the money market and the bond market and the mortgage market and everything else.

MR. PARTEE. They survived.

MR. CORRIGAN. Barely.

MR. GRAMLEY. Recall also that in the first half of this year we had growth rates in one month as low as 1/2 percent and in another month as high as 13 percent. And unless those are anticipated--those rates were surprises, and monthly variations of that kind are always to some degree a surprise--we are going to be accompanying them with very, very large variations of interest rates. I really can't see why anybody would want to go back to the kind of policy we pursued in the fall of '79 and the fall of '82, given the success of what has happened since.

CHAIRMAN VOLCKER. Well, the success of what has happened since depends upon what happens in the coming months.

MR. GRAMLEY. Well, yes. I'm by no means ruling out that with a monetary policy as ideal as any human brain can conceive, given our knowledge, that we're still going to have variations in economic activity. There's just no way that I could buy the argument that the main reason why we had this dramatic slowdown in the economy was because of high interest rates in the spring. I just don't believe that for a moment. Some of it is; the decline in housing surely is. But [with] the increase in the saving rate of 1/2 percentage point or

so in the third quarter, why would you so argue when consumer credit continues to grow? This tremendous drop in net exports surely can't be assigned primarily to the rise in interest rates in the spring. It's a much broader phenomenon there. We can't provide a perfect monetary policy. There's no way.

CHAIRMAN VOLCKER. We can provide a perfect monetary policy if you say we just can't provide a perfect economy.

MR. GRAMLEY. Well, all right; I'll accept that.

MR. CORRIGAN. There's another point, too, on this business of chasing M1 around. Don't forget that since the experience between [October] '79 and early '82 we've had a heck of a lot more deposit deregulation in the banking system and there's a potential implication in terms of the behavior of the real economy. The credit quality of banks and thrifts in the kind of interest rate environment the depository institutions are operating in is, if anything, worse than it was in that earlier period. I don't claim to--

MR. BOEHNE. On the one hand, this is somewhat Mickey Mouse and, on the other hand, it takes us all the way back to 1979! I have a feeling that it's probably a little more than Mickey Mouse and not quite as dramatic as going back to '79. Whether one is for this or against it, it seems to me we're talking in extremes here.

MR. PARTEE. Go right down the middle.

CHAIRMAN VOLCKER. Mr. Kichline, [after my] having given a great endorsement to all business forecasts, would you like to deliver one?

MR. KICHLINE. Well, with my usual confidence I will plunge ahead. [Statement--see Appendix.]

CHAIRMAN VOLCKER. One of the questions that arises [with] the kind of outlook you forecast for next year--whatever the reliability of that may be--is where the risks lie. And is it satisfactory or does it itself imply that one ought to be going for a higher or theoretically lower [outcome]? Where do you lean on policy with a forecast of that sort, if you believe it. It doesn't tell me what the risks are on one side or the other.

MR. PARTEE. I wonder if Jim has any comments about the risks.

MR. KICHLINE. I think the risks on inflation have been changing to the more favorable side as time has gone on. In fact, there are many people--at least on the Research Division staff here--who would like to argue the case for lower rates of inflation in 1985 than in 1984. In particular, the profit margin is extraordinarily high and rather difficult to explain. Virtually all the models and past behavior would suggest a lower profit margin than has been in place for some time. If that profit margin were to begin to erode a bit, one could very readily take a posture of lower rates of inflation. In the shorter run the risks on the energy side--and Ted and I talked a little about this on the oil side--seem to be down rather than up as well. So, I would tilt the inflation side down a

bit leaving real activity alone. On real activity I think the risks are fairly well balanced. We have quite a moderate picture, really. In thinking about real investment, in particular, this year we're expecting close to a 15 percent annual rate of increase in business fixed investment. We have 6 percent for next year. That's consistent with the Merrill-Lynch and McGraw-Hill surveys and it's consistent with the orders [figures]. Who knows what the tax proposals will do? They can cut either way. But essentially it's quite a moderate picture at the moment, and I think the risks there are reasonably well balanced up and down. I would take the same view on the consumer sector, although in the very short run it is confusing to us. So, I think the real side risks are fairly well balanced.

CHAIRMAN VOLCKER. On this profit margin question, I have a very vague impression from looking at the figures, though not closely. You can confirm it on the basis of a lot of careful work, I'm sure. Why do I hear so many complaints from businessmen--pretty much across the board it appears, though it may not be across the board--that profit margins are under pressure? They say "I'd love to raise prices; I can't do it because of imports." But the [overall] impression is that profit margins are awful.

MR. KICHLINE. Well, they came back very strongly. And, as you know, profits as a percent of GNP are at very high levels in an historical perspective and they've stayed there. It's quite clear that there are many industries suffering substantially, but I think there is a severe distribution problem; it depends upon the nature of the industry and the degree to which it's subject to the import competition. I would only say that when you look at the aggregate numbers relative to GNP and other more narrow measures of profit margins they are really quite strong.

CHAIRMAN VOLCKER. [Unintelligible] the manufacturing industry.

MR. KICHLINE. Yes. What we don't see, however, in our own forecast is very much growth from here on out. So, I think what may have been happening is that there was this surge in profits in '83 and that has tapered off in '84. We think especially in the latter half we may be seeing some sick profit numbers. And next year in the staff's forecast, given the rate of growth of the real economy and prices, we have virtually no growth in profits. So, I think, one of the problems here is what businessmen are thinking about--continued very strong growth or maintenance of a high level.

CHAIRMAN VOLCKER. You're looking at so-called economic profits.

MR. KICHLINE. Correct.

VICE CHAIRMAN SOLOMON. Did you see that article in the Sunday New York Times yesterday? The automobile quotas are costing the consumer \$10 to \$13 billion dollars, of which \$6 billion or more increases corporate profits in the automobile industry.

CHAIRMAN VOLCKER. You mean above the [unintelligible] in corporate profits?

VICE CHAIRMAN SOLOMON. No. What they argue is that some of it went into overtime which could have been handled more economically.

CHAIRMAN VOLCKER. Well, I mean the \$6 billion figure.

VICE CHAIRMAN SOLOMON. Yes. The \$6 billion increases corporate profit.

CHAIRMAN VOLCKER. [Unintelligible.]

VICE CHAIRMAN SOLOMON. Maybe you assume they will only break even.

CHAIRMAN VOLCKER. You haven't any evidence, I presume, but how much gossip is there on what these tax proposals are doing? You say theoretically they might increase it. I understand that, but I haven't heard a--

MR. KICHLINE. No, we're agnostic in the forecast. We haven't taken a position. If you believed something were going to happen along the lines of the Administration's proposal, I think there would be an incentive to accelerate equipment purchases to get the favorable depreciation and the tax credit. It's a bit risky on the structures side. If you were into a standard tax shelter partnership trying to turn over commercial buildings, I don't know that you'd want to touch that at all. Basically, it can cut either way. I would say the overriding feature is a healthy dose of uncertainty. And that is rather unhealthy in this environment. There is a lot of uncertainty.

CHAIRMAN VOLCKER. On depreciation: If you invest next year, that accelerated depreciation continues through the life of that investment?

MR. KICHLINE. That's what the Administration has said: that there would be liberal transition rules. Their own numbers, at least [based on] talking to them, [suggest] that in the aggregate their proposals would raise the cost of capital about 10 to 12 percent over the life of an investment. So, it's a substantial potential change.

VICE CHAIRMAN SOLOMON. If everything is indexed on inflation in this new tax proposal, presumably it will take a less high level of interest rates to prevent the economy from overheating.

MR. MORRIS. All the anecdotal evidence I hear in New England indicates that it has had the effect in the short run of putting a lot of investment plans on the shelf until this is resolved. I don't know whether that is true nationally or not, but that's the word I get from industrial people. They will wait and see.

CHAIRMAN VOLCKER. That's what I get, too.

MR. RICE. Especially long-term investments.

VICE CHAIRMAN SOLOMON. But I think the people who are saying this have an ax to grind.

MR. RICE. Sure.

MR. CORRIGAN. Do you people have any feel at all as to how much of housing starts and residential construction outlays in recent quarters is for what would be considered second houses?

MR. KICHLINE. I don't know that we have a good feel for that. There are some scattered [signs] but it's very hard to break out of current starts figures.

MR. CORRIGAN. I think the dollar figure would be even more important because if one looks at all these recreational areas around the country, one sees very, very expensive houses and condos and so forth. They seem to be springing up all over the place.

MR. KICHLINE. Well, it is very confusing. For example, I believe the Administration's proposal is that [a taxpayer] couldn't deduct more than \$5,000 above investment income for interest charges on something other than a primary residence. What that really does is to induce people to take out big loans on their primary residence. And there are other incentives in terms of tax-adjusted returns, but the proposal doesn't adjust the interest paid on a primary residence. In effect, that gives a primary residence preferential treatment and will build in incentives to leverage highly that part of the market.

VICE CHAIRMAN SOLOMON. Coming back to the more basic question that I guess you asked: If you assume [3] percent real growth in '85, you said that the risks of deviating either on the down side or the up side are about even in your opinion. Isn't it true that if there were a major change in the dollar, that would heavily weight the risks on the down side?

MR. KICHLINE. Which way is the dollar going? If it goes up, it would be applying more restraint on the domestic economy. And that's one of the features of our forecast; we've knocked a few tenths off our forecast because we have been assuming in our recent forecast a higher value of the dollar [than we had earlier]. So, in effect, it is draining off income abroad. It's a depressing influence on the domestic economy. I think, Ted, that the assumption in this forecast is about an 8 percent decline in the value of the dollar over the course of 1985 from current levels. Now, if it were to go down much more than that, we'd be talking about lessened restraint on real activity and a better export picture than we're now talking about.

VICE CHAIRMAN SOLOMON. But that would show [up] more in the following year.

MR. TRUMAN. Well, it depends obviously on when it occurs. If it occurred sooner, then you'd get more of it in the 12-month period than if it occurred later.

VICE CHAIRMAN SOLOMON. Just out of curiosity, how do you get something as precise as an 8 percent assumption? You used to do 10 or 15 percent.

MR. TRUMAN. Approximately the same way.

MR. BOEHNE. On this trade business, some of the people in my District say that even if we got a drop in the dollar of some substantial magnitude, that might prevent the further erosion of

business but it wouldn't any time soon or maybe a very long time out in the future cause a turnaround in their business. They say that those companies that are now exporting to the United States would adjust their profit margins or their profits somewhere else to hang on to this newly acquired share of the market at least for a while. So, it would seem to me that the risks of this really speeding up the economy in 1985, even if we got a big drop in the dollar, [are slim]; it probably wouldn't happen.

CHAIRMAN VOLCKER. What are you assuming in the trade balance next year?

MR. TRUMAN. I can't remember the number exactly. It's \$125 billion on average for the year and approximately the same on the current account.

CHAIRMAN VOLCKER. You're saying no further deterioration in the trade balance?

MR. TRUMAN. Well, yes, on average.

VICE CHAIRMAN SOLOMON. We're assuming in New York \$150 billion on the current account.

MR. TRUMAN. Our current account at the end of the year goes to \$140 billion. On President Boehne's comment: In aggregate terms I think the hardest thing to predict is the lag structure of the [effects of] exchange rate changes. Most equations do say that there is some lag in this, which I think one could say is a manifestation of exactly that phenomenon, even assuming some absorption of an exchange rate [change] in foreign profit margins. One way to interpret lags in these equations is that it's not until the exchange rate has gone down or up and stayed there that you get the impact of those exchange rate changes on real trade flows. And it is for that reason that one can be quite skeptical about the precise timing for any given exchange rate change--even a permanent exchange rate change--or how fast it would show through. There are equations around--in fact the Commerce Department uses a technique where they assume that almost all of the adjustment comes in a very short period of time. And that's what led them at one point to make very much more optimistic assumptions in their projections on the current account and the trade balance than we were making at that time because they assumed that there was nothing left in the pipeline. With a forecast of the type that we have--just an 8 percent decline against the background of a 12 percent increase last year--in some sense you have more in the pipeline than you're making up. So it's necessarily the case, at least on the exchange rate side, that you will have some net negative impact most of the year just with the [unintelligible] exchange rate adjustment of the type we would--

MR. MORRIS. What are the interest rate implications of an 8 percent decline in the value of the dollar in the short run?

MR. TRUMAN. There are some components of that in the price forecast, though less than last time, as Jim said, and also in the real forecast to the extent that interest rate projections are somehow related to the demand-for-money equations.

MR. AXILROD. If you get more economic activity and prices with the same money supply, we'd have to say you'll get somewhat higher interest rates than you're thinking of.

CHAIRMAN VOLCKER. Does anybody else want to deliver themselves of a comment at this point? If not, we'll come back and make more pregnant comments in the morning.

[Meeting recessed]

December 18, 1984--Morning Session

CHAIRMAN VOLCKER. Mr. Kichline, what do you have for us this morning?

MR. KICHLINE. With a smile, housing starts are virtually unchanged, staying at the depressed October level of 1.53 million units. Permits rose about 11 percent, however. Personal income is reported to have been up 0.7 percent in November following a downward revised 0.4 percent increase in October. At the same time, personal consumption expenditures on this release, which will go into the flash numbers of the Commerce Department, on their calculation rose 0.9 percent in November following a 0.2 percent decline in October.

CHAIRMAN VOLCKER. Mr. Axilrod, why don't you go ahead and say what you want to say?

MR. AXILROD. Well, Mr. Chairman, the three alternatives that we presented to the Committee in the Bluebook all encompass some recovery of M1 growth from the reduced pace we've had, at least [based on] these present and concurrent seasonals for the second half of the year. The middle one, alternative B, as the chart following page 7 in the Bluebook shows, would aim at getting M1 to a place that's relatively high in the tentative range adopted in July for 1985. Alternative A, which has an 8 percent growth for M1 suggested, would tend to move M1 above that cone. But the parallel dotted lines are intended to show a range of variation around a 5-1/2 percent growth rate over the year 1985, and it would be well within those parallel lines.

We view the specification of alternative B, which is about a 6-3/4 percent rate of growth in M1 from November to March, with an assumption for December on the order of 7 percent, as roughly attainable with current money market conditions. And I might add that those current conditions when we were doing the Bluebook were a bit tighter than the present money market conditions. That is, we viewed that M1 growth as attainable with borrowing of around \$400 million and the funds rate around 8-3/4 percent. In the last several days the funds rate has been below 8-1/2 percent; yesterday it was below 8 percent and this morning it is very close to 7 percent, just about 7-1/16 percent. So, in fact, alternative B calls for somewhat tighter money market conditions than those that have evolved in the last couple of days, given market attitudes and expectations. We think the driving force behind the increase in M1 demand that would lead to this growth under the specified reserve and money market conditions is the fact that we expect growth in the economy to be a little more rapid in the first quarter than it has been in the third and fourth quarters. And we are expecting, finally, to get some effects from the drop in interest rates that has occurred in recent months, which work with the usual lag. At the same time, Mr. Chairman, we expect growth in M2 and M3 to slow from the recent pace under the conditions of alternative B, largely because we expect a drop in interest rates on money market deposit accounts and money market funds as they finally catch up with this drop in market rates. So, we would expect a substantial slowing in growth of those aggregates in the MMDAs and money market funds. Alternative C is an effort to put the Committee at the middle of this 4 to 7 percent range. It is our view, given the projections we have

of the economy, that this would require a somewhat higher fed funds rate and tighter reserve positions than alternative B.

I ought to add, Mr. Chairman, that I do have some additional monetary figures for the week that we haven't published, the week of December 10. I don't have any data for the following week now, but I will have some later. We had expected an increase of almost \$5 billion in M1 for that week and it now appears to be \$3.6 billion, somewhat less of an increase. So, it looks like December will be lower unless the figures for the 17th, which we'll have later, turn out to be stronger than our expectations. It is a somewhat more moderate M1 picture for December as of this moment than we had at the time this document was written.

MR. CORRIGAN. What's your best guess now for that number for the month as a whole?

MR. AXILROD. Well, I'd really rather wait until a little later when I get [some data for] the 17th.

CHAIRMAN VOLCKER. December will turn out to be lower unless it's higher! That's about what that projection is worth.

MR. AXILROD. The only other thing I should mention, Mr. Chairman, is that we did suggest some bracketed language in the operating paragraph of the directive because the Committee had in the last directive wanted to take account of the shortfall in M1 growth in October and in the fourth quarter relative to the 6 percent it had decided on early in the quarter. We have suggested language that would continue [to convey] some of that concern. If you adopted alternative B, for example, it would permit more rapid growth in M1--above the 6-3/4 percent--from November to March should you want to continue to take account of the fact that M1 did come in quite a lot lower than the original [objective of] 6 percent. Alternative A in some sense tends to allow for that more than alternative B and we wouldn't consider that language necessary if the specifications were as high as those of alternative A.

CHAIRMAN VOLCKER. I think the time has come for some general reactions but before you do that I would like to suggest that you comment on several specific things. We are approaching the time for [setting] long-term ranges for 1985. Indeed, in a couple of weeks we are going to be in 1985. We have some preliminary long-term ranges for 1985 and I think you ought to put your comments in the context of what you think the appropriate longer-term ranges should be in a general way, whether similar to or the same as we had in July or, if different, in what respect different. In the same vein, [views] about the relative weight of some of these monetary aggregates or other factors might be relevant. You can add anything on operating techniques that we discussed a bit yesterday; that would be relevant too.

We also are going to have to present some forecasts for next year and we will get those between this meeting and the next meeting. Let me make a couple of comments on that. There is a question of where we're going and, at this long distance from the end of next year, where we want to go. We have a projection of a little less than 3 percent [real GNP growth] next year, if you take the staff estimate.

That presumably is based upon certain assumptions as to monetary growth. The assumption on interest rates seems to keep changing from meeting to meeting and getting lower, I would think, consistent with those monetary growth estimates. In any event, we're going to have to put forward a projection. And I think that we should consider at this stage at least, since we're making up policy, where we want to be, as they say, as well as where we think we're going to be. If you take the staff's 3 percent [real GNP growth forecast] as a starting point, is that satisfactory or not? I would put it this way: I would have to be persuaded that that's the ideal outcome for next year. It seems to me that the economy has a little more room to grow than that, ideally. Now, I'm not saying we can arrange this all ideally. But if we don't think it is going to grow 3 percent or faster, say 4 percent, I guess the question that arises is: Why aren't we easing? And what are the things that are inhibiting that, if any? Maybe there are some. If we were in a strongly inflationary period, for instance, I guess that would be an obvious inhibition. Is that where we are? Is that a risk? I think some commentary about that would be desirable just in the sense of where the risks are in the economy. As a benchmark, if you are in agreement about taking that 3 percent as a benchmark, Mr. Kichline says that in his judgment the risks [to that forecast] are evenly balanced. I'd like some comment as to whether that's what you think they are in some economic sense. I think there's a question of whether the implications are equally balanced and whether the risks and dangers in the larger sense of overshoots or undershoots from, let's say, 3 percent or wherever you think we're going, are evenly balanced. That comes back to the question of what the risks are of inciting inflation on the one side, I suppose, against inciting [growth] considerably weaker than 3 percent. And some of those quarterly figures that are already in the staff's projection are quite anemic. What are various bits of economic information including, I suppose, the condition of the oil market, commodity markets, gold markets, and exchange rates telling us about that?

Finally, I think some discussion of how this all fits into a larger world setting is relevant. The United States certainly has been propelling, I think almost single-handedly, the world expansion for the past two years. There are not strong signs of self-propelling growth abroad that I can see at the moment. Japan seems to be slowing down a bit from a relatively rapid rate of growth. Europe seems to be talking about--with the help of a large amount of exports to the United States--a growth pattern probably barely sufficient to keep unemployment from rising further. That means growth of maybe 2-1/2 percent. But are we looking at prospects in the United States that in a sense remove a motor from world growth and what are the implications of that? Who's going to make it up, if anybody? If nobody is, what's the implication for policy? I think this inevitably gets involved with the exchange rate question because the strength of the dollar and the converse weakness of other currencies--particularly as that affects prices of imported raw materials, especially oil--and the inflationary impact it has in varying degrees in other countries is a factor in their own policy direction and policy mix and certainly is an inhibition on their monetary policy in terms of moving in an expansionary direction. So, with all those questions on the table, let me open up the [discussion]. Mr. Morris.

MR. MORRIS. Mr. Chairman, I think the staff's forecast is too pessimistic on growth. I would expect growth to be more like 4 percent than 3 percent, primarily coming in the first half, because I think we're going to get a very big response to the decline in interest rates that has already taken place. I think we have to remember that the economy and M1 respond with a lag to a decline in interest rates. We're already seeing some beginning signs such as the rise in permits. We've already had a couple of months of increase in new home sales. There is some auguring that the consumer is coming out of his summer lull, particularly the new car sales in the first 10 days in December. The only sector I'm concerned about is capital spending because of the impact of the tax program--that is, the discussions suggest that the tax program will not go through. I don't really think we have a very good fix now on whether we're going to get an impact--at least a short-run impact--on capital spending plans or not. I would assume that that will be resolved pretty quickly by the President's State of the Union and budget messages. He will have to take a position one way or the other on accelerated depreciation and the investment tax credit. And if he should take the position of rejecting the Treasury's program, I think the decline in interest rates will reinforce the extraordinary incentives and produce another great upsurge in capital spending. So, I'm very optimistic about the first half--much more so than the staff.

CHAIRMAN VOLCKER. Are you unhappy about that?

MR. MORRIS. No. I think we can handle a 4 percent growth rate. The big problem, or the big imponderable, is what is going to happen to productivity growth. I've been very optimistic on productivity, but I must say I haven't gotten much statistical comfort. My optimism is relying on the intuitive rather than the statistical because the big jump in employment in the last two months in an economy that's not growing very rapidly surely leads me to expect very poor productivity numbers for the fourth quarter. But I'm not sure that we're going to get in 1985 the pretty good productivity performance that would make a 4 percent real growth rate very easy to attain without putting inflationary strains on the economy. If we don't get it--if we get a poor productivity record--then I'd have to change my mind on this.

CHAIRMAN VOLCKER. You'd want to put a lot of emphasis on M1, I bet!

MR. MORRIS. No, sir! As I say, I've concluded that M1 velocity is a random walk and I think we have to look at other things. If we ever get back to a point where M1 velocity becomes reliable again, I'd be quite delighted. But I think it would be hazardous for us to make the assumption that that time is now.

CHAIRMAN VOLCKER. You're not thinking of radical differences in the ranges for next year?

MR. MORRIS. No. I think the ranges for next year are compatible with, say, an 8-1/2 percent nominal GNP rise, within which I think a 4 percent real growth rate would be comfortably encompassed. So, if we're going to continue to have targets for the aggregates, I don't see any reason to change any of the ranges.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. Well, Mr. Chairman, let me respond to the questions to us in the order you raised them. First of all, in terms of the tentative ranges for 1985: They look fine to me; I don't see any particular reason at this point to change them. On the question of relative weights and operating techniques: As I mentioned yesterday, I'm not dissatisfied with our operating techniques. In fact, despite the surprises we've had in the economy, I think the performance of monetary policy, as best I can judge it over the past year or maybe two years, probably has been as good as you can get it. Despite the fact that M1 growth has popped around, 1984 is the first year that I can remember, Steve, where we've never actually gone outside the cone; we've been in the cone for the whole year. You raised the question yesterday, Mr. Chairman, about primary emphasis on M1. Part of the problem is that nobody knows quite what that means. I do think that in the fullness of time and over long enough periods of time the behavior of M1 should get a relatively heavy amount of weight, which I think it gets. But I don't think it should get primary weight if that means chasing it around in the short run. Again, looked at in the fullness of time, the behavior of M1 even for 1984 at 5 percent or so doesn't seem to me to be very far from something that I would consider quite acceptable.

On the question of the forecast: In general, I'm pretty close to Frank. I certainly have been quite wrong in terms of my near-term expectations for the last couple of months. But as best I can weed through everything, I still think that the prospects for 1985 are on the stronger side of the staff's forecast, which is fine to me. If I were to try and articulate an optimal--I shouldn't say optimal but rather acceptable--set of goals for 1985, something in the area of 4 percent real growth with an inflation rate holding about where it is looks like a pretty result from my point of view. One thing I would stress, though, is that by a lot of standards inflation, even if it were to stay at 4 percent, is still high. Indeed, when you look at what has happened this year, there is still a question as to why inflation is as high as it is, not why it's as low as it is. I think that has to remain a consideration in our minds, particularly going out into 1985. As Jim pointed out yesterday, the pressures from profit margins are going to increase at least in a behavioral way. Whether they can reflect themselves in higher prices is another subject. I think the two wild cards of note, in terms of the economic outlook, are the trade situation and the tax policy questions. The staff forecast and most other forecasts basically are saying that the trade position will stay about where it is right now. I don't know if that's a safe bet or not. Certainly, as a general proposition, that situation continues to be a source of great uncertainty in my mind. And I don't know how to judge the uncertainties coming out of all these tax policy questions. My hunch is that they will hurt rather than help. The one other point I would make is that I now have the sense that--reflecting the relatively good performance of wages and prices and maybe especially wages--we may in this period have achieved something of a more permanent downward shift in inflationary expectations and in the yield curve. That, again, I think can be a positive development in terms of the real economy in 1985.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. Well, Mr. Chairman, I'll try to answer all of your questions in order as well. But first I'd like to say a word about the forecast. Unlike Frank and Jerry, I'm very comfortable with the staff's forecast; I think it's just about on target. I do not see any danger of a recession. I don't see any of the usual signs or conditions prevailing which usually precede a recession. On the contrary, the basic conditions appear to exist for continued moderate expansion.

CHAIRMAN VOLCKER. Let me just be clear. When you say you're comfortable with the forecast, that means you're comfortable with it as a forecast. And is it also desirable?

MR. RICE. That means I agree with it as a forecast. If I'm taking too long to get to it, I guess I could give you a "yes" or "no."

CHAIRMAN VOLCKER. No, I just wanted to be sure.

MR. RICE. Although there are good reasons for expecting a 3 percent rate of expansion next year, again unlike Frank and Jerry, I don't see anything in the economy that's going to spark an expansion at a rate beyond 3 percent. It may be, as Frank suggested a moment ago, that the recent decline in interest rates has been of such a magnitude as to stimulate further expansion. The decline of the federal funds rate to around 7 percent, as we had today, is something I had not anticipated. And I'm sure the staff forecast is not based on interest rates at these levels. So, one question is whether the funds rate and other short-term rates should stay in the 7 percent area or not. With rates in that area Frank may well have a good point about sparking a faster rate of expansion. But if they don't stay around that level--if funds rates go back up to where they were a few weeks ago or to the 8-3/4 percent rate recorded two days ago and the short-term market rates associated with that go to 9 percent, I really don't see what is going to spark a faster rate of expansion. I don't see it in consumer expenditures; I don't see it in the various components of investment; I don't see it in net exports. I don't know where it would come from.

As the Chairman put it, if the staff forecast is about right, the question arises as to whether that is satisfactory. And my answer is that if that is absolutely the best we can do without inflation, yes, I would settle for a 3 percent rate of expansion. However, I'm not sure that that is the highest rate of growth that is consistent with low inflation. I'm not at all sure. My own inclination is to try for a higher rate. I'm not at all sure that 4 percent is a rate that is consistent with low inflation; 4 percent growth may be too high and may result in capacity or resource pressures. But I think we ought to try to pull for the highest rate of growth that is consistent with low inflation and keeping the risks of igniting inflationary expectations very low. I think we're in a good position to do that right now because the Federal Reserve has an unusual amount of credibility. And I think it's a time that we could use some of the credibility in the interest of getting some further growth. To put it simply: We can play it safe or we can take some risks toward more growth. I don't think the risks will be high. As a matter of fact, as I've already suggested, the moment we see some danger of capacity or resource pressures or wage/price pressures developing or the moment

we see some ignition of inflationary expectations we can and should pull back. Now, let me say that I'm simply trying to suggest an attitude we might take. How does this translate into policy? As I said earlier, interest rates have come down much more in recent weeks than I had thought they would. I'm perfectly prepared, with interest rates at this level, to sit back and wait and see what happens and not push them any further.

CHAIRMAN VOLCKER. When you say this level, I think maybe we ought to discount today's federal funds rate for the purpose of this discussion. It's the last analysis, but--

MR. PARTEE. 7 percent in the--

MR. RICE. What I'm trying to convey is a feeling that things have eased quite a bit, and a lot of what I'm saying applies to an interest rate level that was higher than I thought was good for the economy. So, I would be prepared to sit back and see what effect this [easing] has for a while. And if it isn't producing some kind of support for the economy, why then I'd be in favor of easing somewhat further. But what I'm saying doesn't translate into doing something wild and pushing interest rates way, way down. That's not what I'm talking about; I'm talking about a cautious, probing attitude. We can talk about how to do that, which means numbers like "B."

CHAIRMAN VOLCKER. "B." okay.

MR. RICE. To answer your question about M1: I'm impressed with what the staff has found about the increased reliability of M1. If it has become more reliable in the last 18 months, let's recognize it. That is not to say rehabilitate it completely but recognize it and perhaps consider putting it on equal footing with the other aggregates.

CHAIRMAN VOLCKER. We have it on equal footing right now.

MR. RICE. No, I've never heard anybody say it's on equal footing or is given equal weight.

CHAIRMAN VOLCKER. Two meetings ago we put it rather explicitly on equal footing.

VICE CHAIRMAN SOLOMON. That's the way the directive is written and that's the way the markets are interpreting it now. If anything, they're giving it more [weight].

MR. RICE. Well, the markets were giving it more. We're saying we are giving it more importance, even more importance than a month ago. The markets have long since been giving it greater importance than we have. Anyhow, if everybody agrees that we put it on equal footing with the other aggregates, that's as far as I'd like to go at the present time on M1. As for the ranges for next year, I'm comfortable with the ranges that we've established. However, if we implement this probing attitude that I've suggested we should push for, we should be prepared to see growth in the upper parts of those ranges. Is there something I haven't covered?

CHAIRMAN VOLCKER. Well, you and Mr. Corrigan started out by saying you were going to answer all my questions. You haven't answered the international questions.

MR. RICE. Oh, yes. What I'm suggesting is to try to get as fast a rate of growth [as is consistent with low inflation], which means lower interest rates. And lower interest rates are very consistent with what needs to be done on the international side. As a matter of fact, I think one could make a case for easing monetary policy purely on the exchange rate situation now because of its effects on and ramifications for our domestic economy.

CHAIRMAN VOLCKER. Governor Martin.

MR. MARTIN. Mr. Chairman, with regard to your question as to the "satisfactoriness" of the 2.9 percent Greenbook projection for next year, I have some discomfort with the confidence factor around that 2.9 percent. It's so difficult to forecast today. We have good forecasters here and they have difficulty. I would move away from Jim's position that the risks are balanced. It seems to me that there are some areas that point toward downside risks--notably the reliance on the consumer rather than a BFI-led third year [of recovery], which was the scenario not too long ago. Now we have in our scenario, understandably, the consumer coming back in 1985 and continuing to accumulate debt very substantially, albeit not at as great a rate or for as many dollars as earlier. That curve is very steep, as you will recall. So, we have the consumer, who has been buying cars and durables and buying on credit and accumulating considerable debt, looked on to come back in 1985 and add to that debt very substantially. I'm not sure the consumer is going to do that to that degree. I'm certainly not sure the consumer is going to continue to accumulate that kind of debt in housing, despite some of the positive things that have been said about housing. It's true that housing starts didn't fall much last month, only 0.7 percent. It's true that there have been some positive figures on house sales. But housing prices are not rising in many of the key submarkets around the country and that motivation for taking on housing debt and for trading up in housing is missing. The delinquency rate on the residential mortgage portfolio is at unprecedented highs for this stage of an expansion--over 4 percent. There is no sign of that coming down. Foreclosures are very high. Add to that the need, if you're going to have housing sustained or rise, for an annual rate of 500,000 plus multiple units to the supply in '85 in the face of the syndicators who have been putting up much of this apartment property backing off because of tax uncertainty. Who is going to finance the massive blocks of apartments needed to maintain housing starts at 1.7 million units or some number like that when a third of it has to be multifamily units and the syndicators and the other speculative builders are somewhat deterred by the discussion of a change to the tax situation?

So, I don't think 2.9 percent [real GNP growth] is satisfactory. I think that has a policy implication, Mr. Chairman. I would be a lot happier with a 4 percent plus or minus number rather than 2.9 percent. It indicates to me that we should address our policy in that direction. You raised the question of risks. I think there are risks to the forecast. I think there are also risks in the broader sense. I note that when we reviewed the two graphic depictions of unemployment that we tend to use, the curve showing

insured unemployed has been rising since October, if I can read the graph, and it looks like the number on initial claims for unemployment has been rising since about midyear or July. And we're talking about 2.9 percent growth following two quarters of growth under 2 percent. In real terms we have those two quarters behind us and then an expectation of under 3 percent for a target long term. Take the confidence limit around the 2.9 percent in a broader sense. Let's consider the Congress returning and starting to talk about spending cuts with unemployment rising or at least unemployment claims high. What about the group of political people in and out of the legislatures who would like to take a crack at the Federal Reserve-- who would like to restrict our independence or who would like to have us report in a different way and so forth. Are we willing to take the risk of unemployment and very slow economic growth as those folks begin to look at the Federal Reserve and what should be done? To me that's a risk. I may be exaggerating.

In terms of the world context, I saw a figure somewhere, though I haven't verified it, of 19 million unemployed in the EC. Maybe that's not quite the figure but we know what the unemployment rates are in those countries and the Chairman indicated the outlook for growth there. There are some political and social risks in those countries of continued unemployment at this stage.

The question was raised as to what importance should M1 have. Well, I think among the monetary aggregates it should have the premier position. But I think too that for us not to weigh more heavily the weighted average exchange rate borders on the irresponsible [given] that the exchange rate and the flood of imports into this country impact upon employment and the market share. As Ed Boehne was saying, once that market share is gone, it's gone for quite a while. And what does that mean for employment and unemployment in the next cycle? So, it seems to me that we need to put more emphasis than we have been upon the exchange rate. We need to put emphasis upon M1, certainly. And those indicators that have some reliability and which point toward future inflation, of course, have to be very important. I don't know whether they are more important than M1 or not, but obviously those signs of future inflation are important--the wage and benefit settlements and indicators such as productivity that Frank mentioned. Well, productivity is coming back. Remember that we've had such a disappointment in real growth that, as Frank said, with the services industries hiring people and real growth so low, of course, we have negative productivity figures. But I think that the staff's productivity figures are still too low, although I'm delighted to see that they have raised the trend number a touch. Thank you, sir. But the people I still have occasional contact with have changed their organizations substantially and they are going to get the productivity.

Now, that leaves me to question the ranges for 1985 as the Chairman asked. There I am greatly troubled by our implicit treatment of velocity for 1985. I'm not sure that 6-3/4 percent will be enough, frankly. I'm not sure if velocity behavior is so hard to forecast. I've got 4 percent M1 and V1 for last year. That's somewhat of a surprise, I believe. Talk about confidence level plus or minus around trend velocity! What trend velocity do we need to have 6-3/4 percent be an adequate increase in the short run? What velocity do we need to get the midpoint of the range, to have that 5-1/2 percent be adequate

for M1 in 1985? At 7 or 7.1 percent nominal [GNP growth] for '85, it seems to me the implication is that the top of the range for M1 for '85 may be too low; I would be much more comfortable if we had a little more flexibility there. I don't know whether we ought to go to 8 percent. I know it's the wrong signal in terms of Fed policy whose primary job over time is to bring down the rate of growth in the monetary aggregates in order to counter inflation. But why start off with a situation in which, if we use that darn geometric cone, we're so liable to start out above the upper limit? I'm a parallel line man myself. If these are the categories we're talking about, I think we should seriously consider a higher upper limit for M1 for 1985. And I think we should seriously consider that [complex] of short-term targets which would begin the process of getting a 4 percent plus or minus real growth in the near future.

CHAIRMAN VOLCKER. Governor Partee.

MR. PARTEE. Well, there are a lot of things out there in '85 that are going to happen that we don't have any notion of today. It's looking pretty far ahead and I think all we can do is go on the basis of central tendencies and realize that there will be many surprises to which we'll have to react as the year goes on. I would say that as we go through the third year of expansion, I would have a presumption that the risks are on the side of falling short rather than going over the rate of growth. As the expansion gets older it gets a little more dubious, a little more treacherous to continue to project that we will follow along those lines. In particular, there are two things that bother me about the outlook. The first--and I somewhat tentatively submit it to you--is that there has been a considerable income redistribution in the country both because of the tax changes and because of interest rates. As a result, I'm not sure that we can count on the personal saving rate dropping as it does in the projection. The staff didn't know why it went up, so they are putting it back down again. But if I look around for a reason why it might not go down, it would be that this is becoming a society that is very divided in terms of income results and wealth effects and that kind of thing, and I would expect a higher saving rate because of the fact that a lot of people are prosperous. Now, that doesn't necessarily mean more consumer credit because I would submit that the people who borrow are usually not the ones who have the wealth. They are the ones who need to do the spending. And that makes me somewhat sympathetic to Preston's point that maybe housing won't do so well and maybe automobiles won't do so well as the year goes on.

The second and even more disturbing thing to me is the effect of net imports on the economy that we've seen this past year. It really has sapped the strength of the economic expansion as this year has progressed. The projection says net imports aren't going to go up much more and it could be right, but I really can't see that the situation has changed. It seems to me that the rising tide of imports is just not in the process [of stopping] unless something happens to stop it; it's going to grow and grow more and that's going to sap the strength of the economy as the year goes on. So my inclination, without having a specific forecast, would be to say that the chances are, if anything, that we'll end up on the low side rather than on the high side of an inadequate forecast. The growth rate specified for the year is inadequate. It's inadequate in terms of capacity utilization, which doesn't do a thing as the year goes on; it stays at

82 or a little below 82, as I recall. And it's inadequate in terms of the kinds of stimuli we need in order to get increasing capital spending. Profits aren't going to be doing much according to the forecast; markets aren't going to be improving. We're almost certain to have a gradual shutting off in the business investment expansion with this kind of forecast. So, I think we ought to have in mind 4 percent. I would have said 4-1/2 percent real growth from the fourth quarter to the fourth quarter. I think this kind of forecast is too poor to come forward with, especially when we recognize that we may fall short.

I don't know about interest rates. I've given up forecasting interest rates or even saying what they ought to be because there are so many variables in the equations. For example, someone commented--I think it was Jerry--that maybe inflationary expectations have changed. If they have, these interest rates aren't going to stimulate anything. We are going to [need] lower interest rates because [the current rates] just won't bring forth the demand for credit to spend if people have a lower expectation for inflation and, therefore, a lower anticipation of what they will realize in terms of profit payoffs or appreciation payoffs on the investments they have made. Therefore, I just don't know where interest rates ought to be. I've had that feeling now for some while and it has grown as the years go on. That reinforces my view that we really have to look at the monetary aggregates, not interest rates, as what we hope to control. I'm trying to remember to answer the Chairman's questions, although he's left the room. My view is that M1 ought to have primary importance among the monetary aggregates. That has been my view and there is no change in it. I must say it was strengthened a little by Steve's analysis yesterday but I have felt that for some time and I continue to feel it. I don't know, but I suppose we have selective memories. Lyle can remember the times when M1 didn't tell us anything. I can remember the times when it did--

MR. GRAMLEY. The two of us make a great team!

MR. PARTEE. --and somehow the latter times strike me as being more important. But we always have to be very careful in using M1 because there can be--as there was, I think, in 1982--shifts in the demand for money and we have to be sensitive to that. We don't want to ride our money supply target without regard to what is happening in other elements of the economy or in other aggregates or credit or in market conditions. But among the aggregates I think it is the most reliable and the one that we ought to put the most confidence in. I agree with Pres that we ought to reconsider the long-range targets for 1985. I'm inclined to think that we ought to put M1 growth back to 4 to 8 percent as it was for this year both because we have room for 4 to 4-1/2 percent real growth in the economy and because we've fallen a little short. One way to make the adjustment for the base drift would be to say "All right, we had growth a little lower than we expected this year and we'll take a little higher growth next year if necessary to bring about this 4 to 4-1/2 percent real expansion in the economy. I think that makes a lot of sense. And I don't think in that context that it would be taken as a backing away from our inflation fighting attitude; I think it would be quite acceptable.

I also agree, and I've never said this before in a meeting, that we ought to pay considerable attention to the exchange rate and

we ought to do what we can to bring the exchange rate down. That also would suggest, other things equal, that when we can we ought to do things in the money sector that are apt to produce somewhat lower interest rates. By "other things equal" I mean if lowering rates isn't producing some kind of a calamitous result internally. I don't know whether it's going to bring the dollar down; certainly, it hasn't so far. But I suppose the weight of the evidence over time is that lower interest rates in this country might tend to do that. I wouldn't say we should make the exchange rate the target of policy [unintelligible] or something like that, but I'm very disturbed about this import situation. I think it's just going to have to be dealt with. If the exchange rate does come down--remembering also that a characteristic later on in periods of expansion is that we start to get more inflationary pressures--with lower exchange rates going through the third year of expansion, it seems to me that prices might be on the high side of the staff forecast. I guess I'd be prepared to make some price concession for getting the exchange rate down because I think it's that important a problem. I think I've answered all the questions, so I'll end at that point.

CHAIRMAN VOLCKER. Mrs. Horn.

MS. HORN. I believe the staff forecast represents what is probably the most likely outcome. I'm still uneasy about the outlook, particularly for the next couple of quarters. The pause or the growth slowdown has been greater than I expected and greater than a lot of us expected. In analyzing that, I came up with a couple of events that in retrospect maybe weren't so surprising to me and a couple of events that caused me to focus anew on some existing issues in the economy. The ones I put in the class of maybe being more [surprises of] timing rather than real surprises would be consumer spending and the deterioration in the trade accounts. Those may well smooth out over time. A couple [of developments] lead me to a new focus on old issues. One is that I really do find surprising the extent to which the slowing in the national growth rate is represented in a stalling out of the economic recovery in the Midwest. To use the Ohio state numbers as representative of the Fourth District, employment in Ohio hasn't risen all year and unemployment is now beginning to inch upward. If you look at business in our area, particularly heavy manufacturing, you see the marking down of expectations. They still think the national recovery is going on but they don't think it's going to be reflected in their business, particularly in the traditional capital goods area. So, they're focusing instead on expansion of cost cutting and survival now.

The second set of issues, which I find particularly worrisome, are those surrounding the situation in the farming, mining, and energy sectors. I really see little in recent developments to suggest the end of the income squeeze in these areas. Of course, not surprisingly in that respect--because really only time will deal with those problems--I think the time [will come] to write down some of the inflated asset prices from some of the decisions that were taken under a different set of economic [conditions]. But this remains a problem in many small towns and even some large ones in that we really don't see the spillover, if you will, of the national recovery even if we do expect it to continue on at about the 3 percent rate.

I have two comments specifically on whether I think the 3 percent rate is adequate or not. I'd like to comment on both 1985 and then a bit beyond that. I think probably there is room for more than 3 percent growth in 1985; I might say 3 to 4 percent. But as we look at the long-term trend of the economy and, therefore, at what productivity increases are likely to be, I'm one of those people who are very impressed by some of the productivity stories I hear. Some of the remarkable cost-cutting stories and productivity changes that we have seen in our District are really very exciting. But they do take time to have their effect and I think they take more investment in order to have their effect, and the time periods can be significant before we really reap the full benefit of this. So, as I look beyond 1985, I wouldn't like to place too heavy a bet on a really significant change in the productivity numbers. For that reason, if we're talking publicly about something bigger than 3 percent next year, I'd like to be sure we don't put ourselves in the position where that sounds like more than 3 percent forevermore, because the forevermore numbers I tend to be more comfortable with are in the 2 to 3 percent range. I think if we get involved in more than the 2 to 3 percent range long term, we're counting on a faster quickening of some of the productivity improvements or we're counting on continued enormous numbers of imports to mop up the large demand, and I wouldn't like to be betting on those too far into the future. As far as the longer-term ranges, particularly the M1 range, as I look at them now they are not unreasonable in line with what I just discussed.

CHAIRMAN VOLCKER. Mr. Black.

MR. BLACK. Mr. Chairman, I think the Board staff forecast is about right in terms of the level of economic activity, but I would side very much with Pres and Chuck and Emmett on the risks on that, particularly concerning Chuck's last point. I am fearful that the foreign trade deficit is going to take a bigger bite out of our production and employment than we probably have assumed. If there's any risk, this strength of the dollar in the face of the narrowing interest rate differentials has impressed me a lot and that's where I would think the main risk lies. I think Jerry made a very important point on the inflation side in saying we ought not to be complacent about an inflation rate of 4 percent. I remember that in 1971 when President Nixon put on the wage and price controls that [level of inflation] was serious enough to be a national calamity. By the same token, I think we can pretty well count in our own productive capacity that which is abroad since we have such an open economy now that we're not apt to hit bottlenecks quite as quickly; I think the threat of foreign competition and actual foreign foreign competition have been one of the key reasons why inflation has not risen as much in this upswing as some of us thought earlier that it would. Jim said about the risk of inflation that he thought it would be less next year; I would guess it would be roughly about the same, but certainly less than I earlier thought it would be at this stage.

On the long-run targets, I would come out about where Karen did and would leave those ranges unchanged. So far as the aggregates are concerned, I'll take a page from Orwell's Animal Farm and say that all aggregates are created equal but some are more equal than others and I would emphasize M1 since I think it really, despite its limitations, conveys more information than all the others do and certainly more than any one of them does. To your fourth question

about whether 2.9 or 3 percent growth is satisfactory or not, I think Emmett gave the appropriate answer when he said that that's fine if that's all we can get without inflation. Historically, our long-run growth rate has been around 3-1/2 percent and 3 percent would not be that unusual at this stage of a recovery. But in the peculiar circumstances in which we have found ourselves, I believe that we probably could stand a little more than that. But anything much beyond 3-1/2 percent or so I think would spell problems for us down the road.

And to your final question about how this fits into the world situation: If we don't provide the impetus for expanding world trade, who is going to do it? I suppose that foreign economies look a little better now than they did the last time we met but they still don't look very strong. So, I would expect we're going to have to carry the brunt of that burden; and for that reason I would agree with Chuck that we ought to take a little harder look at exchange rates this time than we've traditionally done around this table.

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. On the outlook, my views have been a little more optimistic than those of others and that has not been very successful so far. I still think there are reasons to think that '85 might come out a little better than the staff forecast. We have the very large budget deficit; we have the diminishing probability that something will be done about it. We've given the economy some kind of a push with lower interest rates in the last few months. But it's also true that one can look at each sector and find something negative. Consumer debt is rising; in business fixed investment there's the tax program and the obvious slow-down; there's the heavy drain from exports. So wherever one looks, there are considerable doubts. That leaves me somewhat agnostic and willing to assume that we are most likely to do a little better than 3 percent but with no great assurance.

Now, as to what is desirable, I would rather not couch that in terms of a rate of economic growth. I would prefer to couch it in terms of certain conditions that are desirable to achieve. Unfortunately, the various conditions, which are very familiar, do not all pull in the same direction. I think we should get the dollar down. At the present level of the dollar we are ruining our trade and we're burdening the country with an international debt, the service of which is going to be a continuing burden on the exchange rate itself. The longer this goes on the lower the dollar will have to be in the long run in order to get anywhere near making income and [outgo] meet. We also, I think, need to get interest rates down. While I agree with Chuck that one can never be sure what interest rates are right--that's why we have aggregates targets--I think it is fairly clear that interest rates in this country and around the world are very high in real terms. They are a drag and are problems for developing countries and their debt. I would like to see something happen that would bring interest rates down. These are all things that call for expansion.

But on the other side there is the inflation rate situation. I share with Jerry and you the view that 4 percent is not good enough. We have to keep bringing it down and we have to realize that this has a cost both in terms of real growth and in terms of the level of

unemployment, capacity utilization, and also in terms of the objectives that I just listed. That is to say: If we want to get the inflation down, it is not helpful to do something that gets the dollar down. If we want to get inflation down more, it is not helpful to do something that brings interest rates down. It is a very difficult compromise. And I lean for the long run toward doing what brings the inflation down, although in the short run I think we may have a window here in which the combined fact that we have a weak economy and weak M1 and weak inflation gives us an opportunity for doing something that would give interest rates a downward push. But that's a short-run evaluation; it's not for the year. In terms of the rate of growth, I agree that over time we have to get unemployment down. But we're in the third year of an expansion and historically it has proved dangerous to try to accelerate [economic growth] in the late stages of an expansion. It has been tried before and it has led to inflation. Sooner or later we're going to have a pause; this economy is cyclical. Whether this pause comes in the third year or the fourth year and whether it means a growth recession or one or two down quarters it seems to me is not unimportant but it is less important than to do the structural things right--that is, inflation, interest rates, and the dollar.

Turning to the ranges, I would keep them as is, recognizing that that means tightening them relative to [those we adopted in] July because we didn't anticipate the down-drift of the base. This will be helpful for inflation. It will not be helpful for growth or the dollar or for interest rates. I think that is the right thing to do, nevertheless. As far as the aggregates are concerned, intuitively, like many, I always look to M1. It's published every week. So, there it is. I think we need to look at each aggregate each time it makes its appearance and ask ourselves whether there is anything untoward about it. There is surely something untoward about M1 at the present time. It looks like an incipient shift in the demand function. I do think that at this time the [broader] aggregates, particularly debt, deserve a careful look. I would weigh all of these and I would give them different weights at different times. Usually I'd give M1 the highest weight but at the present time I would like to have some understanding of why it is weak--whether that is really a weakness that deserves to be corrected or a weakness that has some [causes] that will keep M1 at a lower level.

Finally, as for the international aspect, I think it's enormously important from the point of view of the world to get the dollar down and avoid a situation in which the dollar later may collapse in disorder. That isn't going to be helpful to the world in terms of our current account deficit because our locomotive function in good part depends on the dollar being excessively high. But it's for us an unsustainable and intolerable situation, and the world too in some respects would be better off with a more sustainable level of the dollar. Moreover, I'm not convinced that what we do has all that much of an impact on the dollar. We can, of course, conduct monetary policy in a way that targets on the exchange rate by trial and error: If a little expansion doesn't bring down the exchange rate, a little more expansion can be tried and still more and there is no doubt that eventually monetary expansion will bring the dollar down. But that's not the way I think we want to do it. If we do it in a moderate way, we have to realize that whatever we do is of doubtful effect in the short run as we've seen in recent months when interest rates came down

and the dollar rose. If we could bring interest rates down, that would be the greatest thing we could do for the rest of the world in terms of investment--for other countries in terms of their expansion and in terms of their debt. This is something that we can do only very marginally. If something happens on the budget deficit, I think we should be prepared to respond to that--not by a permanent increase in the rate of growth of the aggregates, which would just mean more inflation, but a temporary increase that would increase the money stock and help to depress interest rates somewhat more than the mere action of a reduction in the budget deficit and in the Treasury's borrowing could be expected to accomplish.

CHAIRMAN VOLCKER. With all this talk about getting the dollar lower and improving the trade balance, let me just introduce another complication. If we don't have a big trade imbalance and a big capital inflow from abroad, how are we going to finance the budget deficit? Mr. Forrestal.

MR. FORRESTAL. Let me start with the ranges, Mr. Chairman. I don't think there is any need to do anything at this time about M1 or M2. I think 7 percent at the top of the range for M1 is sufficient to allow for adequate growth in 1985, provided we keep inflation about where it is and provided that we don't have an unusually low level of velocity. We should not lose sight of the fact--and I think we need to remind ourselves--that 1984 was a pretty good year. I think we did very, very well in terms of growth and, certainly, we did well in terms of inflation. And if you believe, as I guess I still believe but with a greater degree of uncertainty, that what we are in now is a pause and not a permanent decline in the economy, I really don't think we need to do anything with the ranges for M1 and M2. I guess we're not giving a lot of weight to M3 but I wouldn't be concerned if we moved that range up a bit to reflect the reality of what happened in 1984, though I really don't care all that much about it.

With respect to the staff forecast, I think it's a little pessimistic in terms of growth. I think that growth will probably be around 4 percent, but I believe that's good. I would not be terribly comfortable with 2.9 percent growth for '85; that's a bit anemic. I think we can support 4 percent without reigniting inflationary expectations. Why do I think we might get greater growth? I think the saving rate is somewhat important and, unlike others, I believe the consumer is going to break out of this pattern of saving to some extent and we're going to get a return of the consumer to the marketplace. We've seen some evidence of that already in terms of the November retail sales. Perhaps I'm just reflecting my own District where retail sales are holding up pretty well and, in fact, some retailers are even changing their forecasts. I should say that some are moving them down as well. The deficit, of course, is still with us and that is having a stimulative effect on the economy, obviously. I think that we have eased considerably. We have had a drop in short-term rates of roughly 300 basis points. I think that's still going to work its way through the economy. We're expecting more rapid growth; we had more rapid growth of M1 in November. I don't know what Steve is going to tell us about December, but the last number I saw was 6 or 7 percent growth in December. So, I think those things are still in the pipeline and are going to push us to healthier growth--and by healthier I mean 4 percent in 1985. With that greater growth I would expect a little higher inflation than the staff is forecasting. The

other thing that I looked at that I think is rather interesting is the fact that long-term rates have not moved down all that much. What is that telling us? Is it indicating a revival of inflationary expectations on the part of markets or does it suggest an expectation of greater economic growth? I think it's probably the latter. I think the markets are looking for healthier growth in the long run. The other thing that influences me to some extent is the money numbers that I'm seeing from the private forecasters, who are suggesting a fairly healthy growth in M1 in the first quarter of '85.

With respect to the dollar, as others have said, this trade imbalance is a very, very distressing feature of the economy. And if we want to get the dollar down, or at least to help the dollar come down, I suppose one could argue that monetary ease is the way to do it. However, if we do that, the thing I'm concerned about is first of all that we haven't seen the dollar come down at all as a result of the decline in the differential between rates abroad and in the United States. Interest rates have come down here. I would have expected the dollar to come off but it didn't. And the question in my mind is: If we ease policy to bring the dollar down, are we going to reignite inflationary expectations, increase interest rates again, and then bring the dollar back to where it was? In other words, we may get the opposite effect of what we anticipate. So, I'm not sure there is very much we can do on the monetary policy side with respect to the dollar. I really just don't know.

One other thing I want to mention is that in terms of the tax proposal, I think--as others have said as well--that it can cut either way. I find it very difficult to get people to say which way they are going to jump: whether they are going to accelerate their business fixed investment upon anticipation of being grandfathered or whether they are going to hold back. It could go either way, so that is an uncertainty.

With respect to the operating techniques that you asked about, Mr. Chairman, I wouldn't know how to answer your question about placing primary emphasis. I think M1 deserves a lot of attention among the aggregates and I personally would pay more attention to M1 than to the others. But I do think it is very important that we keep our eye on all of the other factors, including economic growth, interest rates, and so on.

CHAIRMAN VOLCKER. Mr. Boehne.

MR. BOEHNE. Based on very recent information, it seems to me that, at least in my District, the retail situation looks a little better. It's nothing to write home about but I suspect December might turn out to be a touch better than November. The more interesting point, as we go out into 1985, is that I believe the risks are on the down side from the staff forecast for two broad reasons: One is just the anatomy of a recovery and the second is the level of interest rates. The point has been made in several different ways, but there is an anatomy to a recovery; there is a rhythm to it. That rhythm is not constant from one recovery to another, but it usually starts with housing and moves into consumption and then it gets a kick from inventories and then investment and so on. To count on a big boost coming from consumption in the third year of a recovery it seems to me is at odds with that usual anatomy and that usual rhythm. It might

happen, but I don't think it's a good bet. In the second area, interest rates, I think most of us around the table say that we've had a drop in interest rates, we've eased and we feel good, so why don't we just wait? It takes a little time; we know there are lags here. I don't think we have lowered interest rates as much as we think we have in terms of the impact on the economy. I think we have seen a bigger drop in nominal rates than we have in real rates. I think we are seeing a downward adjustment in inflationary expectations and I think interest rates are still very high. There is nothing about an 8 percent Treasury bill rate or a little more that is particularly low. And if you look at long-term rates, [they are up] there too. So, in terms of interest rates, I think we still have fairly restrictive restraint on the economy.

So, for both those reasons--the anatomy of a recovery and interest rates--the odds favor a weaker economy than the staff has forecast. I think those kinds of risks are unacceptable, and I think the forecast that the staff has put together is unacceptable. I don't think 3 percent, or 2.9 percent, is acceptable to us. I have a hard time selling myself on it. I think it would be even more difficult to sell that to the public or the Congress or to our friends overseas. So, it seems to me, we have a forecast that is unacceptable. The risks are unacceptable and the policy implication is to try to have a somewhat more stimulative monetary policy to at least move us in a direction that we find more acceptable. I have trouble pinpointing a number but with all the hazards it seems to me something closer to 4 percent or a little over in terms of real growth would be a much more salable outlook and policy target.

As far as the other questions: On the long-term ranges, I must say that my doubts about the ranges that we agreed to last July are on the rise. I'm not at this point prepared in an outright way to advocate raising them, but I think at a minimum we should indicate that growth would be at the upper end and perhaps exceed the ranges, particularly in the first part of the year when we get into the parallel lines and the cone business. But between now and February, I may very well change my mind and come down on the side of raising the upper limit both as a way of handling the undershoot and as a way of providing some breathing room to deal with the risks. As far as the weighting of the aggregates, I have never loved nor hated M1. I don't have any particular loyalty to it; I'm very agnostic about it. But it does seem to me that it has looked a little better recently. These weekly gyrations are certainly funny, but it seems to me that the case that M1 is better than it was a few months ago is a convincing case, so I would put it first among equals. I would give it an extra bow compared to the other aggregates. I, too, think--and I don't think I've even ever thought this let alone said it, Chuck--that the exchange rates and the commodity prices are telling us something. I don't know what kind of weight to assign to this but when so many signals in the economy are going one way or another and the aggregates to some extent are giving mixed signals, it seems to me that in a world with that kind of uncertainty there is information to be gleaned from the exchange markets and from commodity prices. And I think both of them tell us that our interest rates are too high.

As far as the operating procedures are concerned, I'm much happier with the way we have been conducting ourselves in recent months than we were a couple of years ago when we were in a much more

mechanistic mold. It does seem to me that while we ought to carry on more or less as we have been with some equal to primary importance to M1 and looking at borrowings, I would not keep both eyes on borrowing. I would look over at reserve growth and if we get ourselves in a situation where reserve growth either shoots way up or begins to fall off, it seems to me that, too, would be telling us something. I'm not for any formal modification, but I think we've got to look at both sides of how we get at this--both reserve growth as well as borrowing. I think that's everything, or at least all you want to hear.

CHAIRMAN VOLCKER. Governor Gramley.

MR. GRAMLEY. If I were to write down a forecast today, it would look very much like the staff's with about 3 percent growth. And I would agree with the staff's judgment that the risks are roughly balanced as to whether or not growth would exceed that or fall short. So, I don't agree with Frank or Jerry in that respect. My thinking has changed over the past several months and I hope it's not because the news has been coming in rather poorly. I think the worst way to forecast is to assume that tomorrow will be just like today. We all know that we can do a lot better than that. But some things have been happening that have affected my own judgments. The most important is the fact that the drag from the international sector is turning out to be a lot larger, a lot more pervasive, and a lot more persistent than I had anticipated. And the second is the evidence coming in over a series of months suggesting that the process of very rapid growth in business fixed investment is behind us.

Turning to the desirability of this forecast, I certainly would agree with those who say that it would be much more desirable for growth to come out on the plus side of 3 percent than on the minus side. And I say this less for domestic reasons than international ones. Growth of 3 percent is still above my estimate of potential. It's also above the staff's estimate, which is why we make further progress in reducing unemployment with this forecast in 1985 according to the staff. But I don't think a 3 percent growth rate is satisfactory from the standpoint of the international economy. There is just no evidence of any developing dynamism or cumulation of the recovery in Western Europe. And if our economy grows at 3 percent or less, I think the risks increase that maybe the international economy generally is going to begin to stall, with consequences that I think are quite serious. Let me just say a word or two about the exchange rates. I think all of us want to see a lower exchange rate and I assume we all mean a lower real exchange rate. We all know that it's very, very easy to produce a lower nominal exchange rate. All we have to do is dump out money in buckets and gin up double digit inflation and the exchange rate will fall. All we would have to do is signal that we intend to do that and we would get some anticipatory movements, I'm sure. But what else we could do from the standpoint of monetary policy to bring the real exchange rate down, I don't know. If we foster more growth in the U.S. economy, will that raise or lower the exchange rate? I'm not sure. We're told that one of the reasons the exchange rate is as high as it is is because the investment prospects look so much better here than they do in Western Europe. If we lower interest rates in the short run, will that do the trick? Well, we've done that in recent weeks, and lo and behold the exchange rate turns around and goes back up again--according to some arguments, at least, because holders of dollars figure that interest rates have

reached a temporary floor and may turn around and go back up again. I'd like to know what to do to bring the exchange rate down, and I think there is a way to do it, but the policy lever is not in our hands. It's in the hands of those who set fiscal policy. What do we do about the desire for more growth than 3 percent? If I may take a page out of your book, Mr. Chairman, let me remind us all that forecasts are often inaccurate. It may happen that we will get more growth than that 3 percent.

MR. PARTEE. Or less.

MR. GRAMLEY. Or less, that's right. It's not clear at this point. I would note also that the staff forecast is for price inflation in 1985 at about the same rate as in 1984. And, as has been mentioned earlier, this is still above our long-run goal. But I would be prepared, over time, to try to conduct monetary policy in a way that would foster more growth than 3 percent if in fact evidence is produced as time goes on that more than 3 percent is not materializing. Now, that to me doesn't call for any changes in the ranges for the monetary aggregates in 1985. I don't like M1, particularly. Chuck and I are going to average one another out here! I wouldn't change the weight we give M1 in our implementation of monetary policy. But I can express my views on the ranges either in terms of M2 or M1 and I get the same answer. We have ranges; I think we ought to use them. That's what they are for. We don't have to hit the midpoint; we rarely do. But the upper limit of the range for M1 is 7 percent. If you add to that the 1-1/2 percent increase in velocity which is a trend increase independent of interest rates, that gives you 8-1/2 percent in nominal GNP. And with a 4 percent inflation rate that gives you 4-1/2 percent real growth, if the expansive forces are there. Or, with a 6 to 9 percent range for M2, an upper limit of 9 percent with no trend in the velocity of M2 independent of interest rates gives you 9 percent nominal GNP. So, I think we ought to sit with these ranges; I'm happy with them.

VICE CHAIRMAN SOLOMON. Isn't it 6 to 8-1/2 percent?

MR. MARTIN. Yes.

MR. GRAMLEY. Make it 8-1/2 percent. Then my arguments for M1 and M2 are completely symmetrical.

MR. PARTEE. They're exactly the same for the upper end of both ranges.

CHAIRMAN VOLCKER. Mr. Keehn.

MR. KEEHN. Starting first with the economy: I would have said a month or six weeks ago that there was every opportunity that we could fall back into a recession. And though the recent indicators have been somewhat ambiguous, [not] doing a lot, I certainly have changed my view. I think there is every opportunity here to stabilize and, indeed, to begin to come out a bit on the high side. With regard to the forecast, I think the staff's forecast is a very reasonable assessment of the way 1985 may actually work out, though some of the underlying statistics in the forecast seem a little on the high side. For example, they are suggesting auto sales next year of about 11 million. That would go back to the rate in 1978 which, if you

remember, was a very, very strong year. I think that looks a little high. Housing starts of 1.8 million also look a bit high. I think the tax bill will cause considerable uncertainty in that area. But net, I think 3 percent is a reasonable assessment of what may work out. With regard to inflation, though I certainly agree with Jerry that the level is high, on the current trend I think the news is uniformly good; I am extremely impressed on both the price and the wage side. People I talk with are simply unable to get price increases of any magnitude to stick at all, even in some of the tighter industries. On the wage side, people I've talked to say that contracts that have been renegotiated in 1984 are continuing very favorable trends--better than those that were renegotiated in 1983 in terms of the length of the contract and the wage costs. I think the productivity side of that is going to continue to be good and, therefore, most people are going to be able to go into 1985 without increases of unit labor costs. I think the trends [in inflation] are very, very positive. I would have said that is the most important thing that we're trying to do. Even if we deliberately gun the aggregates to try to increase the growth beyond what is suggested, it seems to me we run a very substantial risk of losing what we have already accomplished on the inflation front. So, that leads me to say that I would leave the ranges where they are, based on what we know now; things may change between now and February. There have been some compelling arguments to raise them and I understand that; nonetheless, I would leave them where they are now.

With regard to the relative weights, I would not be slavish to M1 but among the aggregates that we use it seems to me M1 has the greatest reliability in terms of how we operate monetary policy and, therefore, I would place greater reliance on M1 next year than we have. The risks here, and I think everybody has said it, are certainly in the exchange rate and the balance of trade. Clearly, there are some excesses here that cannot continue. I don't know quite why they have continued as long as they have. An aside for a moment on the foreign trade side: As we look at the agricultural sector--and I won't spend any time on that--the conditions in the agricultural sector are much, much worse than they have been. Indeed, we are facing some very serious risks in that area. We think that the loss of the foreign market was the single most important cause of the problems that the agricultural sector is currently dealing with. So, the risks as I look at '85 are in the exchange rate and balance of trade areas. If that unwinds, particularly in a hurry, it could cause some unfortunate reactions. I hear what you're saying, Mr. Chairman, with regard to the need to have this imbalance to finance our fiscal deficit. I wouldn't mind bringing that problem into greater exposure as a way of trying to get Congress to do a little more than they are likely to do to bring down the fiscal deficit. Finally, on the international area, if we have continued growth of about the magnitude that we're suggesting, if inflation remains at the level that we anticipate, and if rates continue to come down, it does seem to me that we ought to be providing the stimulus for a continuation of the worldwide recovery. Therefore, that would not, on balance, be a bad performance.

CHAIRMAN VOLCKER. Have you prepared your swan song, Mr. Solomon?

VICE CHAIRMAN SOLOMON. Maybe it would be more appropriate to skip it. I find Lyle Gramley's analytical reasoning very close to mine with one or two very minor exceptions, so I won't repeat. But it seems to me that there are too many uncertainties. They are unusually high in '85, higher really than in the first two years of recovery. [The outlook] is complicated now by the tax program, correction of the budget deficit, the dollar, etc. Under those circumstances, since we can't really know what the results of our actions will be, I would be in favor of very moderate moves--feeling our way as we go along. Under those circumstances, I obviously feel that we ought to maintain the present operating approach and not return to any degree of automaticity, no matter how marginal, because I think that tends to give us a psychological framework that is not conducive. I have absolutely no ability to predict whether the present level of interest rates or a level 1/2 or 3/4 of a point lower is going to give us 3 percent [growth] or give us 4 percent. So, I don't understand the policy implications of posing that question. I know there's a need to present to the Congress some ranges. On the other hand, if the Congress is going to beat the heck out of us because we say 3 percent rather than 4 percent, what are they going to do when we have to tell them about a dip in the economy coming along later? I don't think we've abolished the business cycle. So I don't know if that means that much to me. Maybe I'm not being sensitive to the situation in Washington. But I don't have a clear view that 4 percent is that much more significantly desirable than 3 percent, although I certainly agree that a 3+ percent is better than a 3- percent.

The international case for some moderate easing is much stronger than the domestic case. Even though I don't think that a moderate easing of rates is necessarily going to change exchange rates, I think in the very long run the level of interest rates will be a very important determinant of exchange rates. In the short run I think a moderate easing may not have any significant effects. But there are other international objectives to be achieved from a moderate easing of interest rates. So, it seems to me that we ought to maintain the ranges where they are and I think they're permitting enough growth in M1 and M2. I'm not quite sure why we continue to leave an M3 that seems to be misaligned on the low side year after year. From what my staff tells me I believe we have tended over a rather longish period of time to see higher M3 than we would normally expect in relation to M2. I don't see any tactical problem or public relations problem in upping the M3 figure. I don't think it's [necessary] by any means, but I throw that out for what it's worth. I think I've touched on all the points that I find significant.

CHAIRMAN VOLCKER. Mr. Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. Things are much clearer to me now as I return to the room. Let me say that I'm grateful to Jerry Corrigan for having captured, I think rather fully, my view of what will happen in '85 and what is appropriate to happen in '85. Let me just recap, because it has been a while since he spoke. With respect to the outlook for the economy, I believe that the staff forecast is a bit conservative; I would look for something more in the range of about 4 percent in '85. And that comes from the fact that the interest rates have come down. Given the lag effect, I think that we're going to see the consumer come back into the marketplace in the first half and that the first half will be somewhat

stronger than is now being projected and the strength will carry through a good part of the year. As a result the 2.9 percent, I think, is a little low. I'd rather we focus someplace between 3 and 4 percent, and closer to 4 percent for the year as a whole. The question is whether that's an appropriate growth. I think we would be right on track if we could achieve that kind of performance in 1985.

With regard to the ranges for 1985, I think what we adopted in July would be quite appropriate and it seems to me that there is latitude within those ranges. However, I would also give some recognition, Mr. Chairman, in your testimony or otherwise, to the fact that unless we rebase we would be in the upper half of that range or near the top and perhaps even [above it] for '85 because of the shortfall we've experienced in 1984. With regard to your question on M1, some may have misunderstood what I said yesterday with respect to the importance I would place on M1. I believe it has greater informational content than the other aggregates, either M2 or M3 or credit. As a result, I would look at it a little more closely, but that does not mean to suggest, along the lines of the question we were asked yesterday, that I'd place primary weight on it. I would not do that because I think the aggregates in and of themselves are only one of several informational variables that we should be looking at in the economy and everything else. I think what we've been doing in the most recent past is quite appropriate. I wouldn't ignore M1; I'd just put a little more weight on it than I would on M2, M3, or credit.

With regard to the exchange value of the dollar, everybody has spoken on the importance of moving its value to some lower level, and I think we all would agree that that would be helpful to the United States and in a sense helpful to the debtor nations around the world. But I'm not convinced that we can do very much to correct that problem. As others have said, if we aggressively target monetary policy with that as an objective, it seems likely that it will backfire on us and we'll be back with a problem at least as serious as we have now and perhaps even more serious. The point I've come to is that it certainly is not totally within the power of this Committee or monetary policy to correct the excesses that now appear in that market. To the extent that we run U.S. monetary policy in a way to benefit our economic activity domestically, I think we have to leave it to the politicians and to fiscal policy to do the remainder. That does not suggest that we shouldn't nudge interest rates a bit more with that being one of the primary objectives. But if we were to set upon a course to correct the imbalances in the dollar vis-a-vis other currencies, I think we would be making a very great mistake. And that's said in the context of looking at my own District in which agriculture plays an important part and, as Mr. Keehn has already observed, the dollar itself is perhaps the only remedy to the situation--and it is a very serious one--that we find in the agricultural sector. But still, with that kind of background, I am not convinced that what we do with monetary policy will affect the exchange rate in any long-term beneficial way.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLE. Is 3 percent enough? Probably not. Is 3 percent likely to be what we achieve? I think my staff would agree that that's probably the best we can hope for, given the present circumstances. The reason I take that view is that we do have some

barriers to getting higher than 3 percent in growth. Just yesterday when the huge current account deficit of--what was it?--\$32 billion for the third quarter was announced, the Secretary of Commerce again pointed out, to his credit, that the real cause of this strong dollar against the huge trade deficit was the federal budget deficit. Unless or until something is done about that, I'm afraid we're pretty limited in our ability to bring down exchange rates and to eliminate that great source of distortion in our whole economy. I continue to feel that we're not capturing what the whole problem of the U.S. economy is by simply distinguishing between a 3 percent versus a 4 percent economic growth rate for next year. There are sectors of the economy --and we're all aware of them--that simply haven't participated in the upsurge of 1983 and 1984 and prospectively for 1985. That's true of many kinds of agriculture--as has already been observed around the table--most parts of the mining industry, and the whole forest products industry. And many types of manufacturing that either compete against imported goods or that rely heavily on export markets haven't participated in this prosperity; they wonder where the prosperity is. There's so much I'd like to see done in the U.S. economy, but as several people have already observed--Lyle Gramley among others--we simply don't have all the variables under our control. And those variables have to do with the huge size of the federal budget deficit for starters. That has been exacerbated further, I'm sorry to see, by the tax reform proposal, which has now placed an additional element of uncertainty out there in the business community. I keep hearing, quite recently now from our own board of directors, that greater uncertainty hangs over the outlook for business capital spending and for certain parts of the housing industry, especially second homes which, if this tax reform goes through, would lose some of the present tax benefits in terms of deductibility of interest. It's frustrating in other words, Mr. Chairman, to want to do better and to think we could do better than 3 percent but to realize--which is where I come out--that we don't have our arms around all the problems in the sense of having the controls at our fingertips.

In terms of what we ought to do on the ranges for next year, I am a strong believer in M1, as I think you all know, and because of the undershoot in M1 we've seen thus far this year I think there is a possible case for rebasing even though it has been very unpopular around this table so far. Simply put, it would permit us to bring down the ostensible range of monetary growth for next year because we'd be taking off from a higher base. That is, a 4 to 7 percent range would be appropriate in my view only if we were to rebase. I'm concerned by the fact that I think the drop in interest rates, which I welcome, will have the effect of reducing the velocity of money in 1985. Unless we're prepared to offset that, we could have an unintentionally restrictive effect on the economy, as was the case to a much larger extent in 1982 when we were too slow to recognize what was going on in the very sharp drop in the velocity of money that year. So, if we were to stick with the fourth quarter as the base for ranges for next year's monetary growth, I would certainly hope that you would make it clear in your testimony that we would aim for the upper part, if not the upper end, of that 4 to 7 percent range. I would be a little happier if we could rebase and have a higher takeoff point for the 4 to 7 percent. If we don't do that and we're going to use the fourth quarter of this year as the base, which now seems

likely given the views already expressed, then I too would favor, as some others have, moving to a 4 to 8 percent range.

With respect to the world economy, I just don't know how much further we can go than we have already in encouraging strong economic activity abroad [through] this tremendous surge of imports we've had in the United States. That has been good for other countries; it has been perfectly bad for a lot of our own industries. And I for one am going to start worrying more about the health of our economy at home in 1985, in view of at least the four major depressed sectors I've already talked about. I think there's a real limit on our ability to do something about bringing down those exchange rates and interest rates without some major risks of over-expansion on the monetary side. Coming back to what Jerry Corrigan and some others have said: That 4 percent inflation outlook is not exactly the best of all possible worlds; I'd like to see the inflation rate somewhat lower than that over a period of several years ahead. I come out, bottom line, that while I recognize all of these things I'd like to do, I'm afraid that until federal finances get straightened out we're pretty much limited in our ability to do what many of us would otherwise like to do.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. Well, Mr. Chairman, with respect to the economy, my own position would be that growth is likely to be closer to 4 percent than to 2.9 or 3 percent. I don't say that with a great deal of confidence but that's where my bias seems to be. For one thing, I'm not entirely sure what the full effect will be of the ease that we've undertaken recently. I don't think we've seen the full effect of that. I think we're seeing some positive effects, but I'd be a bit cautious in terms of trying to do a whole lot more at this time until we can assess that a little better. Reference has been made to all the uncertainties over which we have no control, uncertainties about which it is questionable exactly what, if anything, monetary policy could do.

As for the long-term ranges for '85, they continue to look okay to me. I don't have a strong view one way or the other on Tony Solomon's point about the cosmetics of M3, but basically I'm satisfied with the tentative ranges that have been established. I do think M1 is important. I wouldn't characterize it as primarily important. It is something, though, that I would be inclined to pay a little more attention to. On the operating procedures, as I tried to indicate yesterday, I think the conduct of operations has been really quite satisfactory; if a slight adjustment would help the mechanical day-to-day process, I wouldn't have any really serious question about doing that.

On the exchange rate problems, I agree with the views that have been expressed. It's one of the most serious issues that we have out there. It's a very, very real dilemma because anything that we do will cut both ways. I just have no satisfactory solution to suggest, although I have some feeling, much as John Balles said, that maybe we ought to be trying to do something about that over which we do have some control, which is our own domestic situation. My bottom line, Mr. Chairman, is that the word that keeps coming to me is patience. I think we're in a period now where patience is extremely important. There's always the desire to do something and I'm in favor of doing

something provided that we get the desired result. Since I'm not sure what doing something would mean, I would be inclined to be very hesitant and, as Tony said, if we do anything, to do it very carefully and in very small steps.

CHAIRMAN VOLCKER. Mr. Garbarini.

MR. GARBARINI. Mr. Chairman, with regard to the forecast, the Board staff's analysis may very well be what we'll see next year. However, I believe the odds are somewhat more on the side of a shortfall. Why do I say that? Well, I guess we all have a tendency to be parochial as well as having biases and in our District, although signals are certainly mixed and this could be considered just a pause, I think we're seeing what was a relatively nice growth in employment slowing considerably and at least two states have seen unemployment begin to rise. Also, while the tax proposal could easily cut both ways, in the short run it probably will have a tendency to cause uncertainty. And from our discussions with business people, the uncertainty is certainly leading to some inaction. With regard to the satisfactoriness of 2.9 percent, I don't see it. I would prefer that all my colleagues who think that it might be higher be correct. I think the 3 percent level is still not satisfactory.

I am particularly interested in commenting on the operating techniques. I would certainly like to see M1 on an equal footing and would have to say that I'd like to see it on the podium where it could talk to us. However, I would not leave it on that podium and let it talk without paying attention to other things. In that regard, if I may paraphrase the Chairman, I do not think it would be appropriate to give a Mickey Mouse signal by going to absolute weight on M1, if that is not what is going to be done. And I don't hear around this table that that would be the case. I would say again that I believe it should give us some great information.

I share the concerns about the exchange rate and commodity prices, perhaps again [reflecting] parochial considerations in the Midwest. However, I am not sure that this body is in a position to effect any real changes in that regard and any psychological changes that we might see, if they were at the risk of inflation, I would not do.

CHAIRMAN VOLCKER. Ms. Seger.

MS. SEGER. I don't want to repeat what I have said the last couple of months about my concerns about the slowing economy because it would just be boring. I have hoped that the pause that we might be going through would certainly disappear and that the growth rate would speed up, but it hasn't so far. I've not felt that we really were risking a recession, although I do think we were flirting with one or skating on thin ice, you might say, where we'd need a lot of good luck and a strong tail wind to get across in a hurry before the ice breaks through. And that's sort of the way I feel. I think the staff forecast that Jim and his people prepared is probably about right, given what our policies have been. I would like to see more in the way of economic growth, certainly. Also, I think the staff is relying heavily on the revival of consumer spending and I would hate to look at the advance monthly retail sales figure or the auto sales report for the first 10 days in December and conclude from that that

consumers are back on a spending spree because I don't put much faith in either one of those statistics.

In terms of what we should be shooting for, I would like to see economic growth that's closer to 4 percent than to 3 percent. The reasons are a whole long list. One is that if you look at our commodity prices just about any one I could pick--copper, lumber, oil, and even gold, which is getting down close to \$300 an ounce--has been weak and they are still weak. And I think having faster growth in this economy first of all would stabilize some of these prices that have been falling rapidly and in effect would help the industries that produce lumber or copper, for example. Also, I think that faster growth amazingly would help corporate profits--maybe not so amazingly, since that's the way it usually has happened in the past. When you get faster economic growth and more rapid growth in sales volume, since companies today tend to have a tremendous amount of more or less fixed costs, the additional volume tends to drop through to the bottom line. That, in turn, relieves some of the pressure on businessmen or women to raise prices because their profits are rebounding without the benefit of higher prices. Believe it or not, this also helps productivity. If you look at corporate balance sheets and income statements over the last 20 years in which this move toward a larger chunk of fixed cost and capital investment has occurred, when there is more rapid growth and faster output, the person standing there is not [only] pushing a button that starts a machine but the machine [also] produces 10 percent more an hour and the one guy is still standing there. This does tremendous things for productivity growth as well as for profits. By the way, both of those factors, I think, would be a positive in the capital spending picture. With the negatives in the capital spending picture--namely, the question mark about possible tax hikes or how the tax reform measures will actually shape up when Congress and the Executive branch get through--I feel that the uncertainties have been forcing many businesses to set their plans on the shelf until they see exactly what is going to materialize. But I think we can offset some of that uncertainty by having the better profit performance. And, for sure, a lower interest rate would help to get some marginal projects, short payoff kinds of projects, approved and through the mill even with the uncertainties about taxes.

It seems to me that we would have to change monetary policy more toward ease in order to achieve the 4 percent or 4 percent plus growth that I would like to see. There's no doubt about it. But if we did, then I think the declining interest rates would have some additional benefits besides helping on the growth side--namely, we still have to deal with this problem of the fragility of the financial system worldwide and particularly in this country where we still have thrift institutions with big problems. We have the third world debt situation which, as I understand it, has not gone away. I just visited both Kansas City and Dallas and those people tell me there are problems [in their regions] with agriculture and with the oil industry. This is a minority view, but I also think lower interest rates would help on the dollar side. It may not help immediately, but if we drop our interest rates or pursue an easier monetary policy here, then that would allow other countries to pursue an easier monetary policy. Even if they matched us on the down side basis point for basis point, it still would help each of our economies even if the differential did not change at all. Ultimately, if that did lead to a speed-up in the economic growth of, say, the major European countries,

I think that should help our export situation and eventually might even have some positive impact on the so-called super dollar.

Let's see, there's one other thing I wanted to mention. Should we emphasize M1, M2, or M17? As I indicated yesterday, I'm not particularly a narrow monetarist; in fact, I'm not a monetarist at all. But I've talked to a lot of people who do follow what the Fed is doing, the so-called Fed watchers. Many of them advise major investors. They are movers and shakers on Wall Street and in commercial banking. And my feeling is that, as long as they think M1 is important and they emphasize it and they hang around every Thursday afternoon a little after 4:00 p.m. with bated breath waiting for that number to come out, then it has achieved an importance even when we don't want it to. Certainly, I would never argue that we should look just at M1, but I think we should pay plenty of attention to it and particularly when we set the targets for next year make sure that the bands for M1 growth are adequate to give us some faster economic growth. I would argue, too, at least in the early part of the year, for viewing this in a parallel line fashion rather than as a cone just to broaden out those numbers and for suggesting that it's okay to hit the upper end of the range rather than shooting for the midpoint or cruising at the low end. That's a lot; I think I've hit everything I wanted to say. Thank you.

CHAIRMAN VOLCKER. I think we can have some coffee. The preliminary indications we have for the following week on the money supply are for a negative figure, which does not make December look particularly high at this point. Let's go have some coffee.

[Coffee break]

CHAIRMAN VOLCKER. If I may, I will make some preliminary comments in reaction to the go-around this morning. Really, I just have two. One is that I heard a lot of talk about getting the dollar down and there was a certain amount of talk that that may not be the easiest thing to do. It worries me a little to talk too casually about getting the dollar down, and I do think that we may have more difficulties in the future than we have now with the dollar beginning to go down too fast. We have this basic dilemma of how to get the budget financed, and we're going to have a big current account deficit no matter what happens for the next 12 months. Maybe to put it too starkly, if we have a lack of confidence in the dollar, we're going to have a real picnic in maintaining a decent level of interest rates or a degree of confidence in the inflation outlook in the next year. I do think we have a problem internationally and much of it is of our own making; and we have the disequilibrium in the budget. Perhaps the best thing that can happen is along the lines of what Ms. Seger has suggested: If there is a tendency for the dollar to decline, I suspect that other countries will ease; and given that they have enough room to ease, that might be healthy not only in their own context but if they expand a little more and have a little more confidence in their own currencies, that might over a period of time help to relieve the pressure on our trade position through greater expansion abroad and the dollar may come down in a healthier atmosphere. I simply am a bit sensitive to saying that it's an objective of policy to get the dollar down regardless; I don't think that puts us in a very good posture. I have no problem at all with the view--and in fact I strongly believe--that the strength in the

dollar gives us room to ease, all other things equal. And that ought to be a factor in our considerations. In listening to most people, I get the feeling there's more concern that growth will turn out a little less than the staff has projected than a little more. Combine that with a view that it would not be totally satisfactory even if growth ended up precisely where the staff projected it, and it seems to me that gives you a bias toward some degree of further easing.

We've spent a long time discussing all these general problems this morning. Let me try to shorten the process now and see whether I'm successful in that by suggesting something like alternative B so far as those numbers are concerned. But I certainly wouldn't mind rounding them off, given a healthy skepticism as to whether we're going to meet any of these numbers anyway and how precisely we're going to meet them. Consistent with that--or maybe inconsistent with it as now written but I will assert consistent with that, particularly if we're willing to see some greater growth than what we provide for here, which I assume the directive will say--I would ease the pressures on reserve positions to the point of almost no pressure. Borrowing would be, let's say, on the order of \$250 million. And I'd be inclined to put down a federal funds rate range [of 6 to 10 percent, which is] consistent with alternative A, since the current rate is about halfway in between [the "A" and "B" ranges] now and I'm not sure I'd want to contemplate the rate going up to 11 percent. In terms of the directive, without getting into the precise language, I'm assuming some sentence along the lines of what we have in there now to the effect that because of the shortfalls we've had, more rapid growth in M1--or we could say somewhat more rapid growth in the aggregates generally--would be acceptable, particularly in the absence of evidence of a strong rebound in economic activity and in view of the strength of the dollar in the exchange markets. It would say something to the effect that we would accept more rapid [monetary] growth unless we saw the economy moving ahead more strongly--distinctly more strongly--than the projections suggest now, as long as the dollar remains reasonably strong in the exchange markets. So, in general terms, that would be a proposal to shoot at.

MR. PARTEE. Would you round alternative B down on M1?

CHAIRMAN VOLCKER. Well, I was thinking of rounding at least the M1 figure to 7 percent.

MR. PARTEE. It will be tough [to achieve], though. We now have indications that December [M1 growth] is sub-par. I think it would be safer, in terms of reaching it, to make it 6-1/2 percent.

VICE CHAIRMAN SOLOMON. Yes, but this is November to March.

MR. PARTEE. And includes December as the first month.

VICE CHAIRMAN SOLOMON. Yes.

MR. GRAMLEY. Is your proposal that we start with \$250 million as the borrowing number? This isn't "B," then?

CHAIRMAN VOLCKER. It's "B" on the monetary specifications.

MR. GRAMLEY. Just take the aggregates specs?

MR. PARTEE. And the money market specs of "A."

CHAIRMAN VOLCKER. I am asserting, based upon lengthy economic analysis and a presumed shortfall in December, that we've got to go with less pressures [on reserve positions] in order to even meet "B."

MR. PARTEE. Yes.

VICE CHAIRMAN SOLOMON. You're assuming that if we start with \$250 million, we'll get a funds rate of 8 to 8-1/2 percent or somewhere in that range? Right?

CHAIRMAN VOLCKER. Well, of course, that would depend upon where the discount rate was.

VICE CHAIRMAN SOLOMON. Yes, assuming no action of the discount rate.

CHAIRMAN VOLCKER. My own guess--and other people tell me I'm wrong--is that it probably would be hanging around a little less than 8-1/2 percent.

MR. GRAMLEY. May I ask where the assertion of \$250 million in borrowing being consistent with the specs of "B" comes from? Does one assume that the economy is not as robust as the staff has forecast and, therefore, transactions demand for money balances does not grow along the lines that the staff has forecast? Or does one assume that, given the state of the economy, the money demand function has been misspecified or fallen or something so we get slower growth of M1? In [the latter] case why do you want to go in this direction? I just don't follow the argument.

CHAIRMAN VOLCKER. My argument is very simple. We've had a constant shortfall all through the fall; we've consistently missed the relationship. And I didn't detect any ebullience about the economy in listening to the discussion around the table, and people would rather see it grow a bit faster than the projection rather than slower.

MR. PARTEE. I think it's true that the forecast has consistently been marked down, too, for the near-term quarters. I don't know where we had the fourth quarter last June, but it certainly wasn't at 1.3 percent.

MR. BOEHNE. I have a question about the operating strategy. If we follow our operating strategy of focusing on borrowing and we run out of leeway, given current operating procedures and the current discount rate, we really either have to change the discount rate or begin to look at reserve growth rather than the borrowing to have any additional flexibility on the down side. Is that a proper interpretation?

CHAIRMAN VOLCKER. I think we've got to look at reserve growth at some point; we probably didn't look at it enough during the fall, as we were constrained by a borrowing number. And this is, in effect, a reflection of it. You reduce the borrowing in view of the fact that there hasn't been reserve growth or you run out of [room to reduce borrowing] and I think at some point you just put in more

reserves. If you don't, you run into this problem of things falling away.

MR. BOEHNE. Either you have to give more attention to the reserve growth or you have to lower the discount rate to have any additional downward leeway, or both.

MR. BLACK. I think what you've said is very sensible, Mr. Chairman. This illustrates quite well why I favor a total reserve target. Under current procedures, we choose a borrowing level and we expect a certain federal funds rate; and to predict what is going to happen to the money supply necessitates a knowledge of the demand function for money that I don't think we will ever have. So, whether this will do what I want, I don't know. But if we were operating on the total reserve target, I would feel that we knew what was going to happen. And I was glad to hear you say that we need more emphasis on total reserves. I think that really is what has been our problem lately.

MR. GRAMLEY. The staff's estimate of seasonal borrowing is \$100 million and the staff says on page 9 of the Bluebook that the frictional level of borrowing--I assume this means adjustment borrowing--is now in the neighborhood of \$150 to [\$250] million.

MR. AXILROD. Yes, but that meant both adjustment plus seasonal borrowing. It may not have been clear, but that's what we had in mind.

MR. GRAMLEY. But when borrowing is getting down, do you view the \$250 million borrowing level, with \$100 million in seasonal, [as] one that approaches the low end of the frictional amount of adjustment borrowing? I think Ed's point is a really good one. If you don't lower the discount rate, you really don't have any target at all. Interest rates could drop a ton.

MR. PARTEE. Except for growth in reserves.

MR. GRAMLEY. But if you're willing to provide that kind of growth in reserves--that is, if you start with a borrowing level which is frictional, then what happens is that you just dump in whatever reserves are necessary. And if interest rates drop down to 6 percent, that's within the 6 to 10 percent range for the fed funds rate, so then that's all right? It's not for me.

VICE CHAIRMAN SOLOMON. I agree: not for me. When the fed funds rate drops down to, say, about 8-1/4 percent, there's going to be such intense and widespread expectation in the market that a discount rate cut will follow very shortly that it would be impossible to resist that. So, unless the Board cuts the discount rate only a quarter of a point, when the second shoe drops then we're really looking at something that brings it down into the 8 percent range. Now, I realize that for good reasons you're reluctant to talk about what the Board might or might not do about discount rate changes. But if we do go as far as \$250 million--[not], say, \$300 or \$325 million--I think the pressure then becomes very strong for the second shoe to drop. It's hard to resist it. Whereas, if we go to the \$300 or \$325 million level, at least to start with, then the pressure would not be quite as great.

MR. PARTEE. I'm prepared to support your proposal, Paul. It's getting so that this period of poor business news is extending too long and I think we now have to probe. I don't, as I said, have much confidence in saying what kind of interest rates are appropriate or not. I think what we need is monetary expansion and we're not getting it. If, in fact, that December 17th number holds up to be a decline, we're going to have a hard time [getting] any decent number at all in the month of December. That will make another month in this long string and I think we now ought to be more aggressive in seeking monetary expansion. I'm not shocked at the idea of a frictional level of borrowing at all, nor with a further significant drop in short-term interest rates. And it may be that the discount rate would have to move. I don't want to prejudge that, but it may be that it will have to go [down]. So, I think it's a reasonable suggestion.

MR. GRAMLEY. Should we not focus also on a number like M2, which went up 15 percent at an annual rate in November? I suppose this downward revision of M1 means perhaps some downward revision of M2. The forecast that you have here for December is 13 percent?

MR. AXILROD. Yes.

MR. GRAMLEY. That's been telling us that maybe what we're looking at is a circumstance in which what monies would have gone into NOW accounts earlier now are going into MMDAs, giving you the same interest rate effects.

MR. PARTEE. Well, except that I think the money is coming into MMDAs and money market funds from the open market because of the stickiness in those rate levels.

CHAIRMAN VOLCKER. I suppose one can argue that in earlier days it would have gone into M1 and given us a good boost in M1. I don't think the most recent business news was so awful obviously in the last month but it has been pretty sluggish for some time.

MR. PARTEE. It was reported--I've forgotten whether it was here at the Open Market Committee meeting or at the Board briefing--that Commerce is not giving much weight to that November retail sales figure.

CHAIRMAN VOLCKER. Well, in fact, Commerce doesn't know what the fourth quarter will be, whatever number comes out tomorrow.

MR. MORRIS. Well, Mr. Chairman, I think there is a danger of overreaction here. I feel very much the way Lyle does. We've had a declining period of interest rates here for only the last three months. There are lags in the response of the economy and in the response of M1 to that change. I think we ought to give a lot of weight to the fact that interest rates have declined substantially over a very short period of time and do a little more looking to see if we're getting responses from what we've done before we take a major further move.

CHAIRMAN VOLCKER. I don't see anything very major here but it's a matter of taste, I suppose.

MR. MARTIN. Mr. Chairman, I would support your proposal for a 7 percent M1 and a frictional borrowing level. We've had some revisions in what a frictional level is; we are in a position of making up for a shortfall that seems to be haunting us. We must be aware too that the way our decisionmaking has to go--properly go--is structured by Congress [unintelligible] some decades past. We seem to be after the fact and late. It seems to me that the kind of proposal that you made gives us flexibility; we're not irrevocably committed to a large move. And I think it is timely, considering the data both on the economy and the monetary aggregates.

MR. WALLICH. Some kind of downward push on short-term rates I think, is a good thing, but it depends very much what happens at the long end. It depends also, of course, on whether it would have to be reversed. What are the chances of a sharp drop in the funds rate being followed by a rise?

MR. AXILROD. Mr. Sternlight may have a different view, but I myself think that there's very little chance [of that] at this particular junction, looking over the next four or five or six weeks. But I really ought to say that if you're thinking of \$250 million of borrowing, the funds rate is going to rise from the 7 percent area; it's likely to be somewhere around 8-1/2 percent, given the present discount rate. It's not the money market specs we worked out for alternative A. In our own minds [that entailed] an even lower level of borrowing and somewhat higher excess reserves to drive the funds rate further down. I thought I would add that minor point for clarity.

MR. STERNLIGHT. To add to that, I think the \$250 million of borrowing is likely to give you a steady state kind of situation--a funds rate very close to the discount rate, although we're not really in a steady state and the market widely expects something to happen to the discount rate. So, I expect \$250 million of borrowing for the next little while to be associated with fed funds trading closer to 8 percent on average as the market broadly expects something on the discount rate. As to the long-term rates, I think there will be a slight declining effect from lower short-rates. I wouldn't expect a perverse effect on this occasion.

MR. WALLICH. There is the other question: Would one have to anticipate a substantial reversal at a later time?

MR. AXILROD. Well, the fundamental [issue], I think, is one's view of the basic strength of demand for goods and services and inflationary expectations. Among the staff, views differ very widely on that. If you view our judgmental projections and compare them with straight model projections, things will differ. Our forecast implied, essentially, as Governor Gramley mentioned, velocity of about 1-1/2 percent for M1 next year. That is something like trend, probably. Taken literally, that would mean very little change in interest rates over the course of the year--maybe up a little or maybe down a little. If your view of inflationary expectations and demand for goods and services is even weaker than the staff forecast, then I would think interest rates, in a sense, would be lower than that. It seems to me very difficult to come to a judgment at this point on whether they are going to go up or down.

MR. WALLICH. But you wouldn't say that simply by putting in reserves now one would generate a situation that tended to reverse itself at a later time and made a rise in interest rates likely, independently of how the economy goes?

MR. AXILROD. It's hard for me ever to view it independently of how the economy goes. I really can't answer it independently of that, Governor Wallich.

MR. MARTIN. But note the risks in what Steve has just said. We have a 7 percent target for M1; growth has been falling short of target from time to time. The instability in the velocity figure quarter-to-quarter is notable. Velocity can be 4 percent off, 5 percent off, 7 percent off. [Unintelligible] an error of a hundred basis points. If velocity is flat or even negative--and it conceivably can be negative, though obviously it's not the most likely outcome--then the 7 percent specification for M1 is not very high in terms of velocity.

VICE CHAIRMAN SOLOMON. But that's not the key issue.

MR. PARTEE. I would like to argue for 6-1/2 percent, Pres, because I do think that [7 percent] implies too much for January and February. Unless something really happens here, we're going to have 4 or 5 percent [M1 growth] in December, and if we say 7 percent for the 3-month period, that implies something in the very high single digits for January and February and I think that's pressing too hard.

VICE CHAIRMAN SOLOMON. But why is it so important? Given the situation, the difference between 6-1/2 and 7 percent is going to have relevance only if over a period of time--not the first few weeks, certainly--we find that we have significant money growth. Otherwise, it's not going to make any difference at all. What's going to influence everything in the next few weeks is the drop in the borrowing level and any type of change in the discount rate. So, I don't think the fact that December is going to have slow growth is of much importance, and I don't think the difference between 6-1/2 and 7 percent has that much [relevance]. It's a small chance that we would be up in that range where it's going to make a significant difference of any kind later in the quarter.

CHAIRMAN VOLCKER. Just arithmetically, I guess what that implies is 4 percent growth in December and 8 percent in the other three months.

MR. PARTEE. It's a 4-month span.

CHAIRMAN VOLCKER. Yes, but if you get 4 percent in one month and 8 percent in three months, you get 28; that divided by 4 is 7.

VICE CHAIRMAN SOLOMON. I think the real decision that is facing the Committee--I'm not talking now about the directive and what happens over the period of a quarter, because we are working under a system where there is substantial flexibility--is whether we want to see in the very near term, say, in a week or so, as much of a drop [in the funds rate]. I think Peter Sternlight is right, as I said earlier, that [the proposed borrowing level] would take the rate down close to the 8 percent level, even if arithmetically it should take it

down to 8-1/2 percent or a shade above. The market psychology is such that it probably will drop to 8 percent because the markets will be expecting a discount rate cut and the pressures will be enormous. So, therefore, does the Committee really want to see that much of a drop that quickly? I think that's the most important issue we're facing, assuming we build the flexibility into the directive the way we have for the last few intermeeting periods. My personal view is that that's too big a drop too suddenly. Personally, I would reduce the borrowing level maybe to the \$300 or \$325 million level. I'd make it more gradual.

MR. GRAMLEY. What is the level of borrowing now, \$400 million? That's what we were targeting.

MR. STERNLIGHT. It's averaging \$260 million so far in this period but we would expect to see some lull.

MR. GRAMLEY. It's a fluky situation we're in now.

MR. CORRIGAN. When the borrowing was \$400 million, what did we think was the steady state of federal funds?

MR. STERNLIGHT. About 8-3/4 percent.

MR. PARTEE. Of course, it's a wild number between Christmas and New Year's anyway because of the statement date.

CHAIRMAN VOLCKER. Mr. Boehne, I see you on the list in lonely splendor.

MR. BOEHNE. I think we need to push the ease button again and I think your approach is reasonable. However, procedurally, I would prefer our easing to be accompanied by a drop in the discount rate. While I think in this period we need to pay a little more attention to growth in reserves, I think not to change the discount rate would shift the emphasis too dramatically. So, I would prefer to see it accompanied with a drop in the discount rate just on procedural grounds and I would prefer rounding M1 up to 7 percent. It doesn't offend me if December M1 growth comes out at 4 percent to have 8 percent in January and February. That doesn't strike me as too much money growth in light of where we've been.

CHAIRMAN VOLCKER. Mr. Balles.

MR. BALLEs. Well, I generally support your proposal, Mr. Chairman. I'm generally in accord with the comments made by Governors Martin and Partee. I think it is time, as Ed Boehne has described it, to push the ease button again. I would remind you that at our Bank, at least, we expect this recent decline in interest rates to show through in an actual negative number for velocity. As well as one can guess this, we think we might see negative velocity for the full first half of 1985. That would not surprise me. Therefore, I don't think we should shy away from what would otherwise appear to be an unusually large jump in the M1 numbers during that period of time. In fact, if there were a mood to go toward alternative A, I would even lean in that direction.

CHAIRMAN VOLCKER. Mr. Corrigan.

MR. CORRIGAN. I don't have any problems with the monetary specifications of alternative B. I think shading to the 6-1/2 percent rather than the 7 percent for the reasons Chuck described may serve our interests better. I have just one other technical comment: You mentioned in your clarifying sentence for the directive, Mr. Chairman, a reference to the economy and the exchange rate. I personally would prefer not to make an explicit reference to the exchange rate because the kind of scenario where there is some suspicion in the marketplace that the Federal Reserve is trying to engineer the exchange rate really scares me in terms of a precipitous drop in the exchange rate, with all that means. So, I would prefer not to put that in the directive explicitly but leave it understood. Now, on the money market side--

CHAIRMAN VOLCKER. Isn't it in there already?

MR. PARTEE. Not in that particular sentence.

CHAIRMAN VOLCKER. It's put differently, but I think it's in there.

MR. PARTEE. It's in there.

MR. BLACK. Line 85 on page 4.

MR. CORRIGAN. The way he was suggesting putting it in the operative sentence was different. I thought you were saying, Mr. Chairman, put it in the sentence that is in capital letters on page 12.

CHAIRMAN VOLCKER. Well, I guess we do have an "international financial market conditions"--

MR. CORRIGAN. That strikes me as a little different than an explicit reference to the exchange rate.

CHAIRMAN VOLCKER. That was what I was thinking of. We had a very explicit reference in the [announcement of the latest reduction in the] discount rate. But, it's a matter of debate. I would phrase it in a way that to me is unfrightening--say, that we might ease further if there is continuing strength in the exchange rate. It wouldn't say we're pushing the exchange rate down.

MR. CORRIGAN. I perceive that situation as maybe being more tentative than others, but I would be concerned about how the market might react to that. On the substance of the money market part of this, I'm not allergic to tapping the ease button but I have a little concern about pushing the panic button. And principally for those reasons, I would favor a more gradual approach, along the lines that Tony has suggested. I do, of course, view the economy as being at least a little stronger than many others here. I could be right or I could be wrong. On the other hand, if we can sneak in a further reduction in interest rates in a context in which I now believe there has been some kind of downward step-shift in inflationary expectations, I think that's fine. But I would prefer to be a little more gentle about the package and I would lean toward Tony's suggestion of sneaking up on it rather than going for the brass ring at one shot.

CHAIRMAN VOLCKER. That seems to me an excessive description of the \$50 million difference.

MR. CORRIGAN. No, I would see it as a more than \$50 million.

VICE CHAIRMAN SOLOMON. It's this discount rate thing.

MR. CORRIGAN. I don't think it's a question of a \$50 million difference. If you go back to when the borrowing level was put at \$400 million, the thought then was that the steady state fed funds rate was 8-3/4 percent. If we were to go immediately to \$250 million, I think the discount rate would have to go with it and it seems to me quite plausible that the fed funds rate could settle in at less than 8 percent. So, you're talking basically about a 75 to 100 basis point move in terms of the operative implications of the fed funds rate. And that to me is just a very, very big step. I'd love to think that we could end up there, but I think it is a very big step.

MR. AXILROD. Just as a technical comment, Mr. Chairman, none of us is an expert on what the market is thinking, but it is not at all clear to me, under current market conditions--the way they were the last two days--that a drop in the discount rate of 1/4 point wouldn't be followed by some backup in market rates. It would be viewed as a disappointment relative to market expectations. I am not certain where this complex of interest rates and borrowing would end up, but I would think it is possible that it could be 8 percent or a shade higher, depending a bit on how operations are conducted, as well as the 8 percent or a shade lower that you suggested. It's just not totally clear to me.

CHAIRMAN VOLCKER. Well, I'll tell you something that isn't perfectly clear to me: that there is a difference between \$300 and \$250 million, whether the discount rate is reduced or not. The Board of Governors is going to have to decide about the discount rate. We had several applications in and, as you know, some were [submitted] with some vigor. I don't know how many minds were persuaded on the Board of Governors. I would suggest that it isn't going to be very critical. It's not very critical in my mind, whichever way it goes.

MR. MARTIN. Steve, isn't there a possibility that a 1/4 point reduction in the discount rate might be interpreted as a last act of the drama--that the market interpretation will be "All right, that is far as they are going to go"?

MR. AXILROD. Certainly--or possibly as [far as] they are going to go for a while.

MR. MARTIN. Life goes on, I can see that.

MR. PARTEE. Just in the interest of clarity, I would think going for the brass ring, Jerry, would be to say we want an 8 percent increase in reserves in general, regardless. That's going for the brass ring.

MR. CORRIGAN. I would agree with that. Any of these things in a behavioral way postulates very substantial increases in reserves.

MR. BOEHNE. Where is the funds rate now? We're kind of sneaking up on something that we've already reached.

MR. STERNLIGHT. The market sees it as 7 percent in an elastic way.

CHAIRMAN VOLCKER. Well, what happened when you went in to drain some reserves?

MR. STERNLIGHT. We drained some reserves. I didn't hear what happened to the funds rate, Mr. Chairman.

CHAIRMAN VOLCKER. Since we're totally preoccupied with this question, why don't we find out?

MR. PARTEE. We'll see what happens.

MR. CORRIGAN. I don't know; it could work that way. Yes, it could.

MR. PARTEE. As a matter of fact, the staff projection is for a good increase in money and we'll have a good increase in reserves if that occurs. But we have had a period of shortfalls that has been going on for quite a while. That's why I said "regardless."

CHAIRMAN VOLCKER. Who else would like to say something? Ms. Seger.

MS. SEGER. Well, I'm an ease advocate and I could certainly support you in alternative B and wouldn't be upset if you pushed over into the dimensions of alternative A, using the \$250 million or so borrowing target. Also, I'd keep an eye on total reserves to make sure that they go along and allow the kind of expansion we need. I realize we don't set the discount rate here but I would like to encourage a discount rate cut of about 1/2 percentage point soon to go with this because I'm afraid that if we don't, we are going to have the market disappointment. Furthermore, if we cut it immediately, it would nudge some of the commercial bankers who have been flirting with the idea of cutting their prime rate into adopting the 1/2 percentage point cut that was launched yesterday.

MR. PARTEE. Did anybody else go today?

CHAIRMAN VOLCKER. I haven't heard one way or another.

MS. SEGER. They are waiting for us.

VICE CHAIRMAN SOLOMON. I checked at 10:10 a.m. and nobody else had gone.

MS. SEGER. But I think this would push them to act.

MR. BLACK. What about that bank in St. Louis, Joe?

MR. GRAMLEY. Let me start by calling attention to a couple of things in the general paragraph that are nits, but I think they might well be picked. In line 9 we have--

CHAIRMAN VOLCKER. What are you looking at?

MR. GRAMLEY. The general paragraphs [of the draft directive]. In line 9 it has "largely reflecting a rebound in auto production." The immediate antecedent of that is "after two months of decline" and [unintelligible] would be a lot better. I'd start the sentence "After two months of decline, industrial production increased somewhat" and then follow with "reflecting." My next one is going to be a little harder to swallow. On line 14 it says: "The information on outlays and spending plans suggests substantially slower growth." "Substantially" has been put in this line even though the staff forecast, although it was revised down from 7-1/2 percent, is 6 percent in real terms for the four quarters of 1985. I think what has happened here is that there is confusion between the fourth quarter, which has been revised down an awful lot, and the longer-run future. The easier way to handle that is just to leave it the way it was without the word "substantially." I'm not going to fight about that.

CHAIRMAN VOLCKER. Neither am I. Is anybody else going to fight about it?

MR. WALLICH. Well, I must say that the slowing in business fixed investment is one of the big disappointments. I don't know if it fits into the exact flow of the data, but in that sense I think it is a major factor.

MR. GRAMLEY. My point is simply that this factor is not an awful lot different than it was the last time and to insert the word "substantially" now when the forecast has been revised down from a growth rate of 7-1/2 percent to 6 percent in real terms sounds like not quite--

CHAIRMAN VOLCKER. Use "significantly"?

MR. GRAMLEY. Well, fine.

MR. PARTEE. The increase in outlays went down quite a bit.

MR. GRAMLEY. Well, the fourth quarter is going to be very low. The shipments data both from domestic sources and based on the import data for October would suggest a very slow fourth quarter. And I thought putting in this word "substantially" maybe reflected a mix-up [between] what is ahead for the fourth quarter and what the outlook is for the more distant future.

MR. AXILROD. We might have been being excessively specific here but we were referring to the current quarter, the fourth quarter, in all this. We really were referring there to the substantial slowing that we're now projecting for the fourth quarter, taking account of the upward revision in the third quarter. That was revised up to a 16 percent rate of growth from the 8 percent we had earlier. So, this is really [a substantial slowing in] the fourth quarter from the third quarter.

CHAIRMAN VOLCKER. I think if we say current information or information for current outlays and take out "plans"--

MR. PARTEE. It's the "spending plans" that's really confusing.

MR. MARTIN. Yes.

CHAIRMAN VOLCKER. Let's take out the "spending plans."

MR. GRAMLEY. That would do it. Then the "substantially" is needed. On the more general issue, I don't want to push the ease button again; we pushed it the last time. I think Bob Boykin's prescription is the right one. What we need is a little patience. We need to remember that monetary policy works with very substantial lags. We've done a lot already. And I take some encouragement from this housing report that came out this morning. The rise in permits is quite strong. Permits are not a forecasting device; they don't tell you anything about what is going to happen in the future but they are a lot better indicator of what is happening now than the starts figures are. And to have the permits go up 11 percent, I think, means that we can be reasonably sure the process of a revival in housing is on the way.

CHAIRMAN VOLCKER. Permits are, in fact, above starts.

MR. KICHLINE. Right. They were 1570, I believe.

MR. GRAMLEY. Starts were 1528; normally permits are about 93 percent of starts.

MR. MARTIN. But what we're leaving out of the housing discussion is the considerable pressure by the central bank against growth in mortgages and against savings and loan participation in joint ventures for builders--reserves and net worth requirements against rates of growth. We've left that out entirely. The funding is going to be a lot more difficult for the builder.

MR. GRAMLEY. Well, next I want to say that I thought we were supposed to be giving equal weight to M1 and M2 and I don't think we're giving any weight to M2. In fact, the M2 path for the fourth quarter is substantially above what we decided it was going to be in September and we're just throwing that out. Nobody is even talking about the fact that we had been expecting 7-1/2 percent growth and now it's 11 percent plus. We ought to think about that. I think we ought to ask ourselves whether or not some of the effects of the ease we've put in are showing up in M2 instead of M1 and if that isn't just as good in terms of what it does for easing conditions in credit markets. I don't think we have to go back to 8-3/4 percent on the funds rate but I would like us to aim for somewhere around the 8 to 8-1/4 percent range on the fed funds rate. I don't want to take back a lot of the ease that's been put in, but I don't want to ease further. And I don't know what borrowing number that would be associated with, but my guess is it would be around \$325 million or thereabouts--maybe a little less. That would be my prescription for policy now.

CHAIRMAN VOLCKER. Mr. Boykin.

MR. BOYKIN. I would certainly agree with what Lyle says. As you said a little earlier, Mr. Chairman, you don't see much difference

between \$250 and \$300 million [on borrowing]. Why don't we just go for \$300 million?

MR. BLACK. Do you agree with Lyle because he paid you a tribute? Or is that an honest--

MR. BOYKIN. No, I agree with Lyle because of his very astute analysis.

MR. GRAMLEY. I promised to give him a quarter if he said that!

MR. BLACK. I think you've each given each other a quarter!

MR. BOYKIN. No, I just think he says it better than I can; I just agree with what he's saying.

MR. BLACK. Watch him, Lyle, because sometime he will pay you a tribute and then he will turn around--!

CHAIRMAN VOLCKER. Would anybody else like to contribute to this? Mr. Guffey.

MR. GUFFEY. I don't know whether it's a contribution or not: I have no quarrel with your prescription on the aggregates but I do share the concern about the \$250 million borrowing level. To accept it, one must accept the premise of the staff that \$250 million is at or above the frictional borrowing level. I'm not at all convinced, in view of the extent of the seasonal credit provisions, that that necessarily is above the frictional borrowing level. If it is not, we certainly will be establishing a federal funds rate, it seems to me, and I would accept Lyle's prescription that 8 to 8-1/4 percent is about the correct range. I would like to have some assurance that that's what we're looking at if we're going to adopt the \$250 million borrowing level because I have a concern that if that level is below the frictional level, we'll essentially turn loose any control other than establishing the federal funds rate. In that connection, I've just observed that everybody is talking about a fourth-quarter growth rate in M1 that's very low. But if you are willing to believe that a seasonal adjustment factor might put as much as an additional 2 percent in the second half, that together with some benchmark revisions could bring growth up in the 4 to 5 percent range for the fourth quarter, which would be quite acceptable. We may be pushing the ease button a little before we have all of that knowledge. As a result, I would prefer to see a discount rate decrease by the Board of Governors and then to establish a borrowing level at least above the \$300 million range with the target being a federal funds rate in the range of 8 to 8-1/4 percent.

CHAIRMAN VOLCKER. Is there any reason to believe the change in seasonals would add as much as 2 percent?

MR. AXILROD. Well, on the assumption that M1 in December was going to be 7 percent, we re-ran [the seasonal adjustment program] and the second half was raised by 1/2 percent at an annual rate and the first half was lowered by 1/2 percent at an annual rate. I think I put in a footnote in that document for yesterday. But I should mention that this is well before we have any benchmarks and you can't

tell what the variable month-by-month benchmarks are going to do to this. So, I don't have any evidence at this point that it would be nearly as large as President Guffey mentioned. But the weaker it gets in the second half, the more [the seasonal] goes up a little. But that leads you down a very funny road.

MR. GRAMLEY. No matter what we do we're going to get the same number for December!

CHAIRMAN VOLCKER. Governor Wallich.

MR. WALLICH. Well, I think this is an opportunity for giving interest rates a push because none of the immediate penalties that we usually face in relation to money supply, and in fact on the exchange rate, seem to apply at this time. I think interest rates have been stuck at levels that in a broad sense are not equilibrium rates but have been carried over from the past. So a push may get them to a fractionally lower level that might last, if this isn't immediately reversed by something that happens in the market. And I think it would be worth trying. It would have to be accompanied, probably, by a discount rate cut. I just wouldn't want to prejudice what we should do for the rest of the year in taking a year-out view. But in this immediate window, I think we have an opportunity for lower rates. By that I mean that if we do what you propose and [also] cut the discount rate, we might have a chance of lowering the level of interest rates in a structural underlying sense. And then when they move again, as of course they will, they might not make up this particular drop altogether.

CHAIRMAN VOLCKER. Governor Rice.

MR. RICE. I support your proposal, Mr. Chairman. It's essentially in a range that I'm pleased with.

MR. AXILROD. Mr. Chairman, I should have added in response to President Guffey's question that of the 1/2 point increase 1 percentage point was in the fourth quarter. So it's concentrated there. But again, I don't know how it would work out.

CHAIRMAN VOLCKER. Mrs. Horn, we haven't heard from you.

MS. HORN. I support your proposal, Mr. Chairman.

CHAIRMAN VOLCKER. Let's look at the language a bit--going back from whether or not the borrowing proposal is supported. What about the federal funds range? It seems to me that where the rate is now makes it reasonable to say 6 to 10 percent, but I don't know whether everybody else agrees. Nobody else commented on it, I guess.

SEVERAL. I would support it.

CHAIRMAN VOLCKER. Well, let's assume it's going to be 6 to 10 percent. Now, let me start with some language Mr. Axilrod gave me here. I suppose what we need is "In the implementation of policy in the short run, the Committee seeks to reduce somewhat..." I think that encompasses everybody. To say "maintain existing" may be a little confusing, given the last statistics that came out.

MR. STERNLIGHT. Well, I'm going to respond to your question earlier about what happened over the course of the morning. The funds rate was 7 percent. We went in to drain some reserves. We got a lot of offers--\$7 billion plus--and we did just \$1 billion. Funds were last trading at 6-3/4 percent.

VICE CHAIRMAN SOLOMON. They have their bets; they are ahead of us.

MR. MARTIN. They are ahead of us.

MR. GRAMLEY. Well, maybe that indicates that the level of frictional borrowing is \$300 million instead of \$250 million. At \$250 million now the bottom is falling out of the funds rate. This is a very dangerous course of policy. Interest rates can drop with no bottom. There's just no way we're going to limit them, if it turns out that the estimate of frictional borrowing is wrong.

MR. MARTIN. But if we have 6 to 10 percent and it approaches 6 percent, we limit it. That's not zero.

MR. GRAMLEY. If you're prepared to live with a 6 percent funds rate, why, that's fine.

MR. MARTIN. For how long--two days?

MR. GRAMLEY. Well, I don't want the fed funds rate to go anywhere near that level. I think we're going way too fast.

MR. PARTEE. That's the whole problem.

MR. GRAMLEY. That's where the disagreement lies.

MR. PARTEE. That's the disagreement. It's really more fundamental, I think.

VICE CHAIRMAN SOLOMON. It would really make more sense for us all to go home and you [Board members] can do a discount rate cut.

MR. MORRIS. Here's another situation where there may be an incompatibility between the borrowing level and the path for total reserves. I think there's incompatibility on the other side of this.

MR. GRAMLEY. And lowering the discount rate is only a partial solution to the problem--that is, if the lowering of the discount rate does, to be sure, [leave unaffected] the frictional level of borrowing. But if what we do with monetary policy, both open market operations and discount rate changes, is send another strong signal to the market that we think the economy must be turning down and, therefore, we're going to push the ease button, don't expect interest rates to go back up again. It isn't going to happen that way. It didn't happen this last time.

VICE CHAIRMAN SOLOMON. Okay, that's true. There's some similarity in our thinking, Lyle. But on the other hand, if we do want some easing, the preferable way of getting it at this point is a discount rate cut. I don't think you have to read quite as far reaching a message; the markets will do what you just said. Now, if

you feel that there shouldn't be any easing at all in the rates, then I think you have a consistent position in also worrying about the message you're giving to the market. There's no way at this point that the market has really exaggerated expectations. I would have guessed at this point that if we were to demonstrate pretty clearly that the funds rate is not going to go below 8 percent, we probably would be able to deflate those expectations significantly.

MR. GRAMLEY. That's the wrong way to get some support.

VICE CHAIRMAN SOLOMON. I'm worried about the frictional borrowing level, also. And it seems to me that one way of doing it is to do a modest cut in the borrowing level and move the discount rate either 1/4, or possibly 1/2 point--or else just do the discount rate cut.

MR. PARTEE. Maybe we ought to let you fellows handle the discount rate and we'll do the open market policy here!

MR. WALLICH. I think a discount rate cut, if it came, would look now like a following action, not like a strong policy signal.

CHAIRMAN VOLCKER. I would note that all these concerns I've heard about declining interest rates for the last three months and not getting the borrowing level too low have been accompanied by a decline in reserves and M1.

MS. SEGER. And the economy.

MR. BOEHNE. As to your specific question, before this general discussion, on the first sentence: Could one say "seeks to reduce somewhat the pressures on reserve positions that have prevailed in recent weeks" to get it away from just the last several days? I think that is really what we're talking about.

CHAIRMAN VOLCKER. Yes, I'm not sure that's very clear. I agree that technically meets the problem, but the markets are sitting there looking at not much more than \$250 million in borrowing in the previous two-week period, right?

MR. STERNLIGHT. Yes.

CHAIRMAN VOLCKER. And they may be looking at something like that again when this comes out, but it doesn't come out for a while. They'd say "Reduce from \$250 million?"

MR. BLACK. Maybe the best thing to do is to say that \$250 million was the target and say "seeks to maintain."

VICE CHAIRMAN SOLOMON. We still can say "maintain."

CHAIRMAN VOLCKER. Well, I'm wondering whether that kind of language wouldn't be less misleading somehow. "The Committee seeks to maintain the recently reduced pressures on..."

MR. BLACK. I think that's a better way to do it.

MR. AXILROD. On Thursday, presuming our numbers are half-way near correct, the borrowing level we're going to publish will be more like \$500 or \$600 million for that one-week period that ends on that Wednesday.

CHAIRMAN VOLCKER. Theoretically, tomorrow--but who knows about these theories--there's going to be a lot of borrowing and the funds rate is going to be 9 percent or 10 percent maybe at 3:00 in the afternoon. In fact, the funds rate is going to be 18 percent and [a major bank] is going to come in and borrow \$2 billion because the funds rate is 18 percent! Now, there may be a miss here in the figures, so I think this is just a question that's--

VICE CHAIRMAN SOLOMON. Since it doesn't get published for 6 weeks, it seems to me that--

CHAIRMAN VOLCKER. It doesn't make that much difference probably, but--.

VICE CHAIRMAN SOLOMON. I don't know; the general trend is down. We could probably leave it simply "reduce somewhat" and not worry about the fact that since Thursday and today there has been--

CHAIRMAN VOLCKER. Well, [the problem] is the previous two-week period or one-week period.

MR. PARTEE. Say "reduce somewhat existing pressures" or we could take out the word "existing."

MR. BOEHNE. Yes, that would be a way to approach it.

SPEAKER(?). I think that's probably the best solution.

MR. PARTEE. That makes it pretty vague.

MR. GRAMLEY. "Seeks to maintain reserve positions" or something like that.

CHAIRMAN VOLCKER. "Seeks to maintain minimal pressures on reserve positions."

MR. BOEHNE. I don't think that sends out the right message on what we've been talking about right around the table. I think the message that comes out from around the table is that we want to ease, so I think the words that we use have to convey that view. And the term "reduce" does that; the word "maintain" doesn't.

CHAIRMAN VOLCKER. Well, we'll leave it "reduce somewhat pressures on reserve positions." Then, "This action is expected to be consistent with growth of M1"--what are we going to put in here? Mr. Axilrod wrote in 7, 9, and 9 percent; we could use 7, 8-1/2, and 8-1/2 percent or 6-1/2, 8-1/2, and 8-1/2 percent. What's your pleasure?

MR. MARTIN. 7, 9, and 9.

MS. SEGER. 7, 9, and 9.

MR. PARTEE. I do like these whole numbers.

VICE CHAIRMAN SOLOMON. I'll trade you. Why don't we do a trade?

MR. BLACK. Do it on this one instead of whole numbers and a fractional number.

MR. AXILROD. I was only technically concerned with the specifications between "A" and "B" and I was trying to find the M2 and M3 between "A" and "B."

MR. MARTIN. And a discount rate [cut] of 1/2 point.

CHAIRMAN VOLCKER. Well, let's leave that open for the moment. Let us try this next sentence. I'm just going to read what Mr. Axilrod has written down: "Somewhat more rapid growth of M1 would be acceptable..." Do you just want to say M1 and not the others?

MR. PARTEE. Well, that's the only one that's falling well short.

MR. GRAMLEY. It's the only one we're paying any attention to also. Now the truth comes out.

CHAIRMAN VOLCKER. I'm tempted to say "Somewhat more rapid growth of the monetary aggregates would be acceptable in light of the currently estimated shortfall in growth for the fourth quarter"--. No, this is only M1.

MR. PARTEE. Yes, that's why it was put that way.

CHAIRMAN VOLCKER. "...relative to the Committee's expectations at the beginning of the period, particularly in the absence of evidence of a strong rebound in the economy and in view of the strength of the dollar in exchange markets." It would be more parallel if we said "particularly in the absence of evidence of continued strength and--. It's the reverse; it's not the absence of the strength.

MR. PARTEE. "Particularly if business continues weak and the dollar strong."

CHAIRMAN VOLCKER. Yes, that would make it parallel all right. How can we make this more parallel?

MR. WALLICH. "And in view of the strength of the dollar."

MR. GRAMLEY. Well, "particularly if business news continues weak and the dollar continues strong."

MR. PARTEE. I think that's exactly what we ought to have.

CHAIRMAN VOLCKER. "Continues weak" isn't exactly right in terms of the latest figures, which aren't all that weak.

MR. GRAMLEY. Change your mind--

CHAIRMAN VOLCKER. "Particularly with evidence of continued sluggishness" or something like that.

MR. PARTEE. That's okay.

CHAIRMAN VOLCKER. "Particularly should evidence continue of sluggish economic growth and strength of the dollar in exchange markets." Now, that raises the Corrigan question.

VICE CHAIRMAN SOLOMON. In fact, I'd take the Corrigan position a notch farther. It seems to me the way it comes out now that some people might read this as indicating that we actually would tighten monetary policy if the dollar began to decline. And that is not the message we're trying to get across.

MR. BOEHNE. Doesn't the next sentence take care of your problem, Mr. Chairman?

MR. PARTEE. This suggests that the sentence relates to growth over the target numbers in the Ms, particularly M1. I guess it is M1.

MR. GRAMLEY. But Tony's point is right. More growth is acceptable because the dollar is high. If the dollar starts to fall, then the implication might be--

VICE CHAIRMAN SOLOMON. Yes, we've got to be very careful about this now. There's a lot of attention being paid in the market to what we might do.

CHAIRMAN VOLCKER. I agree it sounds that way. I don't know whether that's so bad. It sounds like precisely the opposite concern of Mr. Corrigan. You can't have it both ways; you can't object on both grounds.

VICE CHAIRMAN SOLOMON. Okay. But the way it reads now, that's what it sounds like. People may read from that that we would tighten.

MR. PARTEE. Down to 7 percent growth in M1--that's the context in which we're discussing this.

CHAIRMAN VOLCKER. Yes, that's right.

MR. PARTEE. We had an overshoot in M1.

VICE CHAIRMAN SOLOMON. Are you going to have the next sentence?

CHAIRMAN VOLCKER. Well, I think the question remains whether we need either of the next sentences.

VICE CHAIRMAN SOLOMON. What I was going to say is this: If we are going to have a succeeding sentence of some kind, maybe we ought to put in a more carefully worded [reference to] the foreign exchange market consideration instead of trying to get the symmetry in that one. It's a risk.

CHAIRMAN VOLCKER. Well, I don't know how you put it in.

VICE CHAIRMAN SOLOMON. Well, basically what we have always said.

CHAIRMAN VOLCKER. I'm not saying this wording we have is great, but I don't know why we need either of the next two sentences when I look at them.

MR. CORRIGAN. What does the "somewhat more rapid" sentence say now?

CHAIRMAN VOLCKER. We'd say "Somewhat more rapid growth of M1"--or the monetary aggregates, which in this case doesn't change anything else--"would be acceptable in light of the currently estimated shortfall in growth for the fourth quarter relative to the Committee's expectations at the beginning of the period, particularly should evidence continue of sluggish economic growth and strength of the dollar in exchange markets." It isn't the most felicitous wording, in terms of reading it.

MR. PARTEE. I think it's the word "evidence" that louses it up. It doesn't carry through to the dollar. I think if we didn't have those qualifiers, which are only now a reference to acceptance of a larger M1 growth, then there would be a basis for continuing the two parallel sentences afterwards. Maybe something could be done, then, on the foreign exchange value of the dollar there. Otherwise, if we have those qualifiers, it makes the next two sentences seem redundant.

CHAIRMAN VOLCKER. It's hard to get lesser restraint on reserve positions. The second sentence, the "greater restraint" sentence, doesn't bother me; it's the previous one that just seems a little peculiar depending on how low we go [on borrowing]. We can't do much less restraint.

VICE CHAIRMAN SOLOMON. What I think we can do--and the Fed watchers will spot the difference--is keep the succeeding sentence on lesser restraint and move up international financial market conditions to be the first [item in that list]. That gives some consideration to it--"evaluated in relation to the strength of international financial market conditions," etc.

CHAIRMAN VOLCKER. What are you suggesting here? That's correct. You haven't solved the next one. Mr. Axilrod has suggested that we combine the first two sentences. Go back to "In the implementation of policy in the short run, the Committee seeks to reduce pressures on reserve positions consistent with growth" etc. That says, whatever figure we stick in there, we can go further if the growth isn't up to it. We haven't got much further to go. And we don't need either of the [next two sentences]. Well, we could leave in the greater restraint sentence. We certainly don't need the sentence on lesser restraint; we've already said that.

VICE CHAIRMAN SOLOMON. Well, I was going to suggest the opposite: Drop the dangling phrase beginning "particularly" and leave in the sentence, which is more or less similar to what's in there now, as a separate sentence; and move international financial market conditions up to the head of that list.

MR. PARTEE. I'd hate to put that ahead of the strength of the business expansion and inflationary pressures, Tony. I think that really is still our first objective.

MR. MARTIN. Our own economy.

CHAIRMAN VOLCKER. I can give you simpler wording for this: "Somewhat more rapid growth would be acceptable in the light of.... provided economic growth remains sluggish and the dollar remains strong in the exchange markets. We wouldn't tolerate the excessive monetary expansion if the dollar were weak in the exchange markets.

MR. PARTEE. I think "particularly" is better than "provided." Provided is absolute.

MR. MARTIN. Yes.

MR. GRAMLEY. "Particularly provided"!

MR. PARTEE. Well, you can use "particularly" in the same wording.

CHAIRMAN VOLCKER. No you can't, I don't think.

MR. PARTEE. "Particularly if the economy remains sluggish and the dollar remains strong."

CHAIRMAN VOLCKER. Where are you? "Particularly if" or "particularly in the context of continued sluggish growth in economic activity and strength of the dollar in exchange markets." I'm not sure that this fourth-quarter preliminary flash on the GNP is going to look all that sluggish. I don't know what you consider sluggish.

MR. MARTIN. Less than 3 percent.

VICE CHAIRMAN SOLOMON. Under 3.

MR. MARTIN. Yes, under 3.

CHAIRMAN VOLCKER. Well, suppose we said "particularly in the context of sluggish growth in economic activity and continued strength of the dollar in exchange markets."

VICE CHAIRMAN SOLOMON. What is "continued strength of the dollar"? What do you think it means to most people--the dollar climbing further or maintaining present levels?

CHAIRMAN VOLCKER. Maintaining present levels or higher.

MR. PARTEE. It could be interpreted, though--

MS. SEGER. When the popular magazines call it the "super dollar," people are looking at it.

VICE CHAIRMAN SOLOMON. But it would be 180 degrees opposite of what the Committee wants if any significant number of people in Europe or in the United States were to read from this wording that we would resist, through monetary policy, declines in the dollar. That's

not what we're trying to say. That fact that there's nothing in the dollar situation that would prevent us from easing is one thing. Carrying an implication that we would tighten monetary policy if the dollar began to come off is another.

MR. MARTIN. But, Tony, that would be such a departure from the policy of the immediate past. Why would they draw that conclusion from that wording?

CHAIRMAN VOLCKER. I don't think they would draw that conclusion in the sentence talking about more rapid growth of M1 than what we've--.

MR. MARTIN. The basic sentence.

VICE CHAIRMAN SOLOMON. I think it's just a risk. I'm not saying it's a strong probability.

CHAIRMAN VOLCKER. Well, do we leave out the next sentence? What do we do with Mr. Axilrod's suggestion "seeks to reduce pressures on reserve positions consistent with..." That would become more relevant maybe, depending upon the borrowing number we put in here. I must say, as I said before, my range of tolerance between \$250 and \$300 million is immense.

MR. CORRIGAN. There's a historical and understandable bias against answering this question, but within the context of either of those levels of borrowing is it the general expectation of the Committee that the steady state level of interest rates would fall out at below 8 percent? That's in some way the thing that I'm stuck on.

CHAIRMAN VOLCKER. It depends upon what we do with the discount rate. But I think that is a dangerous thing to get hung up on. This Committee has been hung up on that for three months and has not eased as fast as it should have in terms of reserve growth and M1.

MR. MARTIN. If that's a motion, I'll second it.

MR. BLACK. I'll third it.

MR. BALLE. Amen.

VICE CHAIRMAN SOLOMON. I don't know who that reflects upon-- this Committee or the Board of Governors for not having moved faster on the discount rate cut.

MR. PARTEE. Are you suggesting \$300 million rather than \$250 million?

CHAIRMAN VOLCKER. I'm suggesting that I could go anyplace between the two. I thought we attracted a great consensus on some number between those two, which would not bother me.

MR. PARTEE. Like \$275 million.

CHAIRMAN VOLCKER. \$275 million wouldn't bother me.

MR. PARTEE. How about the range of \$250 to \$300 million?

CHAIRMAN VOLCKER. That's fine with me, too.

VICE CHAIRMAN SOLOMON. I still would prefer \$300 million.

MESSRS. BOYKIN and GUFFEY. I would too.

MR. PARTEE. I don't think any of the people who have indicated that position here are going to be persuaded by your giving a few paltry million on reserves.

VICE CHAIRMAN SOLOMON. It's important to us, even if you say it's not important to you.

MR. RICE. But it could make them feel better.

SPEAKER(?). Make it \$300 million.

MR. RICE. Give it to them; make it \$300 million.

VICE CHAIRMAN SOLOMON. For a Christmas present?

MS. SEGER. \$300 million with a 7-1/2 percent discount rate.

CHAIRMAN VOLCKER. I think this whole [paragraph] implies that if things remain sluggish, we will go down below that; I don't think there's anything that doesn't say that.

SPEAKER(?). That's right.

MR. MARTIN. That's what it says.

MR. CORRIGAN. That kind of thing is fine with me too in most circumstances.

CHAIRMAN VOLCKER. I don't think I'm indicating that we can come within \$50 million when we're aiming there anyway.

SPEAKER(?). Look, I'm not really from a world--

MR. PARTEE. That's going to be particularly hard if it's not too--

MR. BLACK. It seems to use the expression of Minneapolis or New York.

CHAIRMAN VOLCKER. Well, we had in mind--on the order of a suggestion--\$300 million or lower to start with and we make the errors on the lower side.

VICE CHAIRMAN SOLOMON. Whose errors are they?

CHAIRMAN VOLCKER. Collective error.

MR. BLACK. [Unintelligible] asymmetrical range of \$250 to \$300 million.

CHAIRMAN VOLCKER. Is that satisfactory?

MESSRS. MARTIN and BOEHNE. Yes.

SPEAKER(?). To whom?

CHAIRMAN VOLCKER. Me, sitting here trying to figure out what to do. We're going to take more chances that it will be below \$300 million than above.

MR. PARTEE. Why don't you take a show of hands for preference?

MS. SEGER. What is the question?

MR. PARTEE. We haven't done a show of hands for a long time.

CHAIRMAN VOLCKER. It would be nice to get a consensus; I'm striving for consensus.

MR. PARTEE. I know you are. That's why I think you might need a show of hands as well.

CHAIRMAN VOLCKER. I'm not sure. We're combining the first two sentences. Do you understand that? We have the second sentence: "particularly in the context of sluggish growth in economic activity and continued strength of the dollar in exchange markets." And we take out the next sentence; it's implied by the first sentence. That next sentence could be left in or taken out; it doesn't bother me. It says that if we really get a significant strengthening in economic activity and inflationary pressures and if money growth is rapid, we'd tighten up some. That seems to me to be inoffensive, and I'd leave that in. Is that the consensus?

MR. MARTIN and MS. SEGER. Yes.

CHAIRMAN VOLCKER. And we put in 6 to 10 percent.

MR. MARTIN and MS. SEGER. Yes.

CHAIRMAN VOLCKER. And the borrowing level, as I now interpret it, is up to \$300 million.

VICE CHAIRMAN SOLOMON. Up to? What is the nuance between \$300 million and below and up to \$300 million?

CHAIRMAN VOLCKER. I tell you the only difference between \$250 and \$300 million is a great big fat nuance to me.

VICE CHAIRMAN SOLOMON. I noticed. If it's such a minor nuance to you, why not try the \$300 million?

CHAIRMAN VOLCKER. Because a lot of people--the majority--want \$250 million.

VICE CHAIRMAN SOLOMON. Oh, do they?

CHAIRMAN VOLCKER. Yes.

MS. HORN. [Unintelligible] the first two sentences, that fits.

MS. SEGER. Maybe in the spirit of Christmas we can give him \$50 million.

CHAIRMAN VOLCKER. And we have. [Let's vote.]

VICE CHAIRMAN SOLOMON. I still don't know what we're voting on. What are we voting on?

CHAIRMAN VOLCKER. Up to \$300 million.

MR. BERNARD.

Chairman Volcker	Yes
Vice Chairman Solomon	Up to \$300? No.
President Boehne	Yes
President Boykin	Yes
President Corrigan	Yes
Governor Gramley	No
President Horn	Yes
Governor Martin	Yes
Governor Partee	Yes
Governor Rice	Yes
Governor Seger	Yes
Governor Wallich	Yes

CHAIRMAN VOLCKER. Okay, I guess we're finished.

[Secretary's note: At this point the group ate lunch in the Board room. During lunch, the following exchange occurred:]

CHAIRMAN VOLCKER. I'm afraid we left one thing open at the Open Market Committee meeting. We'll have to regather. We talked about the precise numbers to put in but didn't pin them down. The options were 7, 9, and 9 percent or 6-1/2, 8-1/2, and 8-1/2 percent. I guess I was assuming 7, 9, and 9 percent when we were voting but if other people were not assuming that, we ought to reconsider it.

MS. SEGER. That's what I put down. I voted for 7, 9, and 9.

MR. WALLICH. I voted thinking 7, 9, and 9.

MS. HORN. I could vote for either.

MR. CORRIGAN. I assumed we were voting for 7, 9, and 9.

CHAIRMAN VOLCKER. Well, if that was the general assumption, we'll leave it at 7, 9, and 9.

MR. PARTEE. That's what I assumed too.

CHAIRMAN VOLCKER. Okay.

END OF MEETING